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THE BANKRUPTCY CODE AND RECEIVERSHIPS – CRACKING THE CODE

Producer: Ira Bodenstein

Panelists: Kyra Andrassy, Kathy Bazoian Phelps, Hon. Steven Rhodes & Jason Weiner

NATIONAL ASSOCIATION OF FEDERAL EQUITY RECEIVERS

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SESSION PRODUCER:	Ira Bodenstein, Cozen O'Connor
SESSION PANELISTS:	Kyra Andrassy, Smiley Wang-Ekvall, LLP
	Kathy Bazoian Phelps, Diamond McCarthy LLP
	Hon. Steven Rhodes, United States Bankruptcy Judge (Ret.) Eastern District of Michigan
	Jason Weiner, Esq., Highline Law, PLC

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Stays and Third-Party Releases

Stays

Stays in Bankruptcy

When a debtor files a bankruptcy petition, the bankruptcy code provides the debtor with the protection of an automatic stay. Section 362 protects the debtor and its estate by immediately staying any attempts to enforce or collect prepetition claims, like litigation, lien enforcement, and other similar judicial or non-judicial actions, and other actions that would affect or interfere with property of the debtor or of the estate. 11 U.S.C. § 362; See 3 Collier on Bankruptcy P 362.01-.02 (16th 2020).

The stay is automatic – debtors need not take any action to effectuate the stay after a debtor files a petition. The debtor isn't even required to serve process or give notice. Actions that violate the stay will be void or voidable, and are punishable as contempt of court. 3 Collier on Bankruptcy P 362.02.

The purpose of the stay is to provide the debtor with relief from the pressure and harassment of creditors seeking to collect their claims. In addition, the stay permits the debtor to focus on rehabilitating or reorganizing – without having to worry about creditors levying its property. 3 Collier on Bankruptcy P 362.03. Because the stay protects property of the debtor's estate, "wherever located and by whomever held", the automatic stay arguably has global effect. See 11 U.S.C. § 541.

Stays in Receiverships

Generally, stays in receiverships can be similar to stays in bankruptcy. The receiver order, rather than the bankruptcy code, governs the breadth of the stay. For the stay to be effective, a receiver order must identify all property that is "receivership property", and include provisions prohibiting any attempts to enforce or collect pre-petition claims against entity in receivership or take actions that would affect or interfere with receivership property. Courts have recognized the district court's equitable power to stay litigation against non-parties, and the standard for modifying a litigation stay. See SEC v. Byers, 609 F.3d 87, 91-92 (2nd Cir. 2010); United States v. Acorn Tech. Fund, L.P., 429 F.3d 438, 443 (3rd Cir. 2005); SEC v. Stanford Int'l Bank Ltd., 424 Fed. Appx. 338 (5th Cir. 2011); Liberte Capital Group, LLC v. Capwill, 462 F.2d 543, 551-52 (6th Cir. 2006); Big Shoulders Capital LLC v. San Luis & Rio Grande R.R., 2019 U.S. Dist. LEXIS 199341, *7-9 (N.D. Ill. 2005); Ritchie Capital Mgmt., L.L.C. v. Jeffries, 653 F.3d 755, 762 (8th Cir. 2011); SEC v. Wencke, 622 F.2d 1363, 1369 (9th Cir. 1980); SEC v. Wencke, 742 F.2d 1230, 1369 (9th Cir. 1984); SEC v. Wing, 599 F.3d 1189, 1196-97 (10th Cir. 2010); Hill v. Duscio, 2017 U.S. Dist. LEXIS 48699 (N.D. GA 2017).

Unlike in bankruptcy, however, stays in receiverships are not automatic. Stays become effective only after the court enters a receiver order, and only if that order contains a stay. The breadth of that stay also depends on the receiver order. But because the appointment of a receiver is ancillary relief – relief that can only be ordered once a case is already pending – targets of a receivership often receive notice of the potential receivership once the motion to appoint a receiver is filed – compared to a bankruptcy stay, effective immediately when the debtor files the petition. Notice of an impending receivership removes any element of surprise, and leaves the target company vulnerable to the very concern that the bankruptcy code protects against! Where there is an extreme concern of asset diminution, however, proponents can seek to appoint a receiver without notice, in an effort to preserve as much value as possible until the court enters a receiver order. See Federal Home Loan Mortgage Corp. v. Spark Tarrytown, Inc., 813 F. Supp. 234, 235-36 (S.D.N.Y. 1993) (citing Connecticut v. Doehr, 111 S. Ct. 2105, 115 L. Ed. 2d 1 (1991)).

Third-Party Releases

A debtor that successfully confirms its plan of reorganization is entitled to a discharge. Bankruptcy code section 1141(d)(1) provides, in relevant part, that except as otherwise provided in section 1141(d)(1), the plan, or in the order confirming the plan, the confirmation of a plan (a) discharges the debtor from any debt that arose before the date of the confirmation, and (b) terminates all rights and interests of equity security holders and general partners. 11 U.S.C. § 1141(d)(1).

When attempting to confirm a plan of reorganization, debtors sometimes endeavor to protect certain non-debtor parties from third-party claims by including in the plan releases for those non-debtor parties. Sometimes those releases come in the form of exculpations, where the plan protects fiduciaries from liability for the role they played in the bankruptcy process. See In re PWS Holding Corp., 228 F.3d 224, 246 (3d Cir. 2000). Others come in the form of non-consensual, third-party releases that are necessary to protect third parties from potential liability where, among other things, those third parties and their actions are essential to the reorganization. Although this material focuses on third-party releases, and not exculpation clauses, some courts have referred to them interchangeably. See In re Patriot Place, Ltd., 486 BR 775, 823 (Bankr. W.D. TX, 2013) (citing In re Pac. Lumber Co., 584 F.3d 229, 252-53 (5th Cir. 2009)).

Creditors and other interested parties often oppose non-debtor releases and argue that the Bankruptcy Code prohibits them. Section 524(e) provides, in relevant part, that "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). Read together with Section 1141(d)(1), opponents of third-party releases argue that Section 524(e) explicitly limits the discharge of any debt to the debtor, and prohibits any third-party releases.

And then enters Section 105(a). The bankruptcy code section that empowers the court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title[]" and states that "[n]o provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." 11 U.S.C. § 105(a).

For years, circuit courts have been split about whether the bankruptcy code permits third-party releases. That split is often based on whether Section 105(a) permits a court to confirm a plan releasing non-debtor third-parties in the face of Section 524(e)'s explicit limitation on the effect of a debtor's discharge.

The minority of circuits – the Fifth, Ninth, and Tenth Circuits – find third-party releases impermissible.[1] See Pac. Lumber, 584 F.3d 229, 252-53 (Court held that non-debtor release and exculpation clause in plan, protecting third parties from claims of negligence that occurred during the bankruptcy process, must be struck, except with respect to the creditors committee and its members, because Section 524(e) only releases the debtor, not co-liable third parties, and that cases in the Fifth Circuit broadly foreclose non-consensual non-debtor releases); Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394, 1401 (9th Cir. 1995) (Where plan proposed global releases, court rejected authority under § 105(a) to release non-debtors and stated that "This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."); and Landsing Diversified Properties-II v. First Nat'l Bank and Trust Co. of Tulsa (In re Western Real Estate Fund, Inc. et al.), 922 F.2d 592, 600-602 (10th Cir. 1990) (Tenth Circuit rejected the bankruptcy court's reliance on § 105(a) as authority for a non-debtor release and stated that "Obviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third party bystanders.")

[1] The Ninth Circuit recently held that § 524(e) does not prohibit an exculpation clause covering liabilities arising from the bankruptcy proceeding and not discharged debt. Blixseth v. Credit Suisse, 2020 U.S. App. LEXIS 18524 (9th Cir. 2020). In Blixseth, the Ninth Circuit concluded that § 524(e) does not bar a narrow exculpation clause focused on actions of participants in the plan approval process, and relating only to that process. Id., at *14-15. Notwithstanding, the Ninth Circuit's holding supports the Bankruptcy Court's determination that permitting the subject exculpation clause does not violate Ninth Circuit precedent. See In re Yellowstone Mt. Club, LLC, 460 B.R. 254, 268 (Bankr. D. MT, 2011). It has yet to be seen whether and to what extent the Ninth Circuit is still considered in the "minority of circuits".

The majority of circuits – the Second, Third, Fourth, Sixth, Seventh, and Eleventh Circuits – find third-party releases permissible. See Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.), 416 F.3d 136, 143 (2nd Cir. 2005) ("A non-debtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to success of the plan, focusing on the [Dow Corning, 280 F.3d 648, 658 (6th Cir. 2002)] considerations…."); Gillman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203, 212-14 (3d Cir. 2000) (Court suggested that non-consensual releases and permanent injunctions were permissible but, because of the manner in which the issue was presented to it, determined that it need not establish a rule "regarding the conditions under which non-debtor releases and permanent injunctions are appropriate or permissible."); Nat'l Heritage Found., Inc. v. Highbourne Found., 760 F.3d 344, 347 (4th Cir. 2014) (Court confirmed the Fourth Circuit's longstanding rule that non-debtor releases may be enforced in appropriate circumstances, cautioned that they should only be approved "cautiously and infrequently", and that they should be considered in light of the Dow Corning factors (280 F.3d 648, 658)); Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.), 280 F.3d 648, 658 (6th Cir. 2002) (Court held that the bankruptcy court may enjoin a non-consenting creditor's claim against a non-debtor when the seven enumerated factors are present); Airadigm Communs., Inc. v. FCC (In re Airadigm Communs., Inc.), 519 F.3d 640, 655-57 (7th Cir. 2008) (Court determined, based on a natural reading of § 524(e), that it "does not purport to limit the bankruptcy court's powers to release a non-debtor from a creditor's claims" and held that, based on the "residual authority" of § 105(a) and § 1123(b)(6), the bankruptcy court is permitted "to release third parties from liability to participating creditors if the release is 'appropriate' and not inconsistent with any provisions of the bankruptcy code."); and In re Seaside Eng'g & Surveying, Inc., 780 F.3d 1070, 1078-79 (11th Cir. 2015) (Court affirmed bankruptcy court's approval of plan containing non-debtor releases, and finding pursuant "to § 524(e), the discharge of the debtor's debt does not itself affect the liability of a third party, but § 524(e) says nothing about the authority of the bankruptcy court to release a non-debtor form a creditor's claims.").

Most recently, in May 2020, the Supreme Court declined to grant certiorari of, and thereby left in place, a Third Circuit Court of Appeals decision affirming confirmation of a plan that contained a non-consensual third-party release. See In re Millennium Lab Holdings II, LLC, 945 F.3d 126 (3d Cir. 2019). In Millennium, the bankruptcy court confirmed the debtor's plan of reorganization and, in the process, overruled a pre-petition lender's objection to plan provisions providing for non-consensual third-party releases and injunctions. That objecting lender challenged, through an appeal to the district court, the bankruptcy court's authority to confirm a plan releasing its claims in light of Stern v. Marshall, 564 U.S. 462 (2011). Specifically, the question was whether the bankruptcy court, in permitting a third-party release, was resolving a matter integral to the restructuring of the debtor-creditor relationship.

On remand, the bankruptcy court found, and the district court affirmed, that Stern was inapplicable to plan confirmation proceedings. The bankruptcy court held that "the injunctions and releases provisions are critical to the success of the Plan because without the releases, and the enforcement of such releases through the Plan's injunction provisions, the Released Parties would not be willing to make their contribution under the Plan and, absent those contributions, the Debtors would be unable to satisfy their obligations under the [settlement agreement] and no chapter 11 plan would be feasible and the Debtors would likely have shut down upon the revocation of their Medicare enrollment and billing privileges." Millennium, 945 F.3d 126, 137 (internal quotations omitted). The Third Circuit concluded that "[r]estructuring in this case was possible only because of the release provisions." Id. The Third Circuit then stated that its holding was specific and limited, and that "under the particular facts of this case, the Bankruptcy Court's conclusion that the release provisions were integral to the restructuring was well-reasoned and well-supported by the record. Consequently, the bankruptcy court was constitutionally authorized to confirm the plan in which those [release and injunction] provisions appeared." Id., at 140.

I. Usage of Funds Subject to a Security Interest

A. When does the Bankruptcy Code permit the usage of cash collateral?

1. Ordinary Course of Business. Section 363(c)(1) of the Bankruptcy Code provides that where a business is being operated, a debtor in possession or trustee can use property of the estate in the ordinary course of business without notice or a hearing. *See* 11 U.S.C. § 363(c)(1). However, cash subject to a secured lender's security interest may not be used unless the secured creditor either consents or, if it does not consent, the court finds that the secured creditor's interest in the cash is "adequately protected." *See* 11 U.S.C. § 363(c)(2)(B), (e).

a. "Adequate protection" only requires protection from a decline in the value of the secured creditor's collateral package after the filing. *See In re Timbers of Inwood Forest*, 484 U.S. 365, 370 (1988). Under 11 U.S.C. § 361, adequate protection can be provided by one of the following methods:

(i) A cash payment or periodic cash payments to the extent that there is a decrease in the value of the entity's interest in the property

(ii) Granting an additional lien or a replacement lien to the extent there is a decrease in the value of the entity's interest in the property

(iii) Granting other relief, other than allowing the secured creditor an administrative expense claim, that will result in the secured creditor's receiving roughly the value of its interest in the property

b. Thus, where the value of the collateral is stable, adequate protection is not needed. If the collateral is receivables and they are being replaced by new receivables of at least the same amount, then adequate protection would be satisfied by granting the secured creditor a lien against the postpetition receivables.

c. An equity cushion can itself provide adequate protection. *See., e.g.*, *In re Mellor*, 734 F.2d 1396, 1400 (9th Cir. 1984).

2. Outside the Ordinary Course of Business. If the business is not being operated or the expense is outside the ordinary course of business, a debtor in possession or trustee can use property of the estate only after notice and a hearing. *See* 11 U.S.C. § 363(b)(1).

B. Application of These Principles in Receivership Cases: In federal equity receivership cases that involve some operation of a business where a secured creditor has a blanket lien or a lien against receivables, a receiver might first look to the provisions of the order of appointment for guidance and attempt to construct an argument that under the terms of the order, no consent of a secured creditor is required. As an example, in *BMO Harris Bank, N.A. v. Truland Systems Corp.*, 2017 WL 2864947 (E.D. Va. 2017), a district court granted a lender's motion to appoint a receiver over some assets that a bankruptcy court had permitted the lender to take charge of. The receiver and the lender subsequently entered into a management agreement under which the lender agreed to fund certain expenses and both parties agreed that in the event of a conflict between the agreement and the appointment order, the order should control. The receiver was required to defend an arbitration that involved receivership assets, but the lender objected to the use of its funds for that purpose and also sought a sizeable payment from the receivership estate. The dispute was presented to the district court, which ruled in favor of the receiver. It resolved the dispute based on the appointment order, which gave the receiver broad authority to preserve, operate, manage, and maximize the value of the receivership estate, vested him with authority to retain and pay professionals, ensured that the receiver operated independently by preventing all creditors from interfering in any way with the discharge of the receiver's duties, and provided that the receivership was to be conducted solely from funds belonging to the receivership estate. Nowhere did the order required the secured creditor's consent to the use of the cash collateral. The Court therefore found that under the terms of the order, no consent was required.

However, if this argument fails, then in the alternative, the receiver might look to the Bankruptcy Code's provisions on cash collateral to get authority to use cash without the secured creditor's consent.

II. Elimination of Default Interest on Secured Debt

A. <u>The Guiding Principle in Both Bankruptcy Cases and Receiverships</u>: As the Supreme Court held in *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946), "[i]t is manifest that the touchstone of each decision on allowance of interest in bankruptcy, receivership and reorganization has been a balance of equities between creditor and creditor or between creditors and the debtor." In that case, the Court disallowed a secured creditor's claim for capitalized interest, because the contract provided for interest on interest only when there was a default in the payments, and the default here occurred when the company was put into receivership and the receiver was prohibited from making payments absent an order of the court. This principle has since been memorialized in 11 U.S.C. § 502(b)(2), which disallows claims for unmatured interest on unsecured claims. However, secured creditors whose claims are secured by property with a value greater than the claim are allowed interest and any reasonable fees, costs, or charges provided for under the contract or state statute under which the claim arose. *See* 11 U.S.C. § 506(b).

B. <u>Allowance of default interest in bankruptcy cases for oversecured creditors</u>

1. Many courts hold that a chapter 11 debtor is liable to an oversecured creditor for default interest allowed under the agreement, even if a chapter 11 plan cures the default. Most cite to 11 U.S.C. § 1123(d), which provides that if a plan proposes to cure a default, the amount required to cure the default must be "determined in accordance with the underlying agreement and applicable nonbankruptcy law." *See, e.g.*, *Pacifica L51 LLC v. New Investments, Inc. (In re New Investments, Inc.)*, 840 F.3d 1137 (9th Cir. 2016)(finding that there was no basis in the Bankruptcy Code or Washington law to avoid the payment of default interest permitted by a contract to an oversecured creditor); *JPMCC 2006-LDP7 Miami Beach Lodging, LLC v. Sagamore Partners, Ltd. (In re Sagamore Partners, Ltd.)*, 620 Fed. Appx. 864, 869 (11th Cir. 2015); In re Moshe, 567 B.R. 438, 444-47 (Bankr. E.D.N.Y. 2017).

   The outcome in these cases turns on whether the applicable state law permits default interest or disallows it as an unenforceable penalty. *See, e.g.*, *The Prudential Ins. Co. v. SW Boston Hotel Venture, LLC (In re SW Boston Hotel Venture, LLC*, 748 F.3d 393 (1st Cir. 2014); *In re Boulders on the River, Inc.*, 169 B.R. 969, 973 (Bankr. D. Or. 1994).

2. Others generally allow default interest, subject to equitable considerations, including the debtor's financial condition, the difference between the default rate and the non-default rate, whether the lender had any role prolonging the bankruptcy proceedings, and how the default rate compares to the market rate. *See, e.g.*, ; *In re Ace-Texas*, 217 B.R. 719, 723-24 (Bankr. D. Del. 1998); In re Terry Ltd. P'ship, 27 F.3d 241, 243 (7th Cir. 1994); *In re Laymon*, 958 F.2d 72, 75 (5th Cir. 1992).

C. <u>Application of these principles to federal equity receivership cases</u>: In *SEC v. Capital Cove Bancorp LLC*, 2015 WL 9701154 (C.D. Cal. 2015), the receiver sought disallowance of all post-receivership default interest on oversecured claims. Noting that the local rules required that federal equity receiverships be administered as nearly as possible in accordance with the practice of administration of bankruptcy estates, the court held that equitable considerations weighed in favor of disallowing all post-receivership default interest because its allowance would directly harm junior and unsecured creditors and its disallowance would promote the orderly and efficient administration of the receivership estate for the benefit of all creditors. *See also In re Real Property Located at Redacted Jupiter Drive, Salt Lake City, Utah*, 2007 WL 7652297 (D. Ut. 2007)(allowing secured creditors to charge post-receivership interest, but disallowing a claim for default interest that resulted when the pendency of the receivership prevented timely payment on the secured creditor's claim). Query whether the *Capital Cove* case is consistent with the Ninth Circuit cases in the bankruptcy context.

III. Recovery of Costs Incurred to Preserve Assets for the Benefit of a Secured Creditor

A. The Bankruptcy Code Provision on Surcharge of Collateral: Section 506(c) of the Bankruptcy Code permits a trustee to "recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of ad valorem property taxes with respect to the property."

Necessity and reasonableness of the incurred expenses are measured against the benefits obtained by the secured creditor and the expenses the secured creditor would have incurred through foreclosure and disposition of the property. *See In re Compton Impressions, Ltd.*, 217 F.3d 1256, 1260 (9th Cir. 2000). To establish a benefit, the trustee must show in quantifiable terms that the funds expended protected and preserved the collateral. *Id.* at 1261; *see also In re Delta Towers, Ltd.*, 924 F.2d 74 (5th Cir. 1991). At least one court has held that it is not necessary that the expense was not incurred with the purpose of benefitting the secured creditor as long as the secured creditor in fact benefitted from it. *See Southwest Securities, FSB v. Segner (In re Domistyle, Inc.)*, 811 F.3d 691, 696 (5th Cir. 2015).

B. Surcharge of Collateral in Receiverships: This principle has been applied in the receivership context. For instance, in *SEC v. Elliott*, 953 F.2d 1560 (11th Cir. 1992), the receiver sought to allocate some of the administrative costs of the estate to secured creditors, who had benefitted by the receiver's work resolving competing lien claims to the same property. The Fifth Circuit held that it is appropriate to surcharge a secured creditor's collateral for the amount of benefit that it actually received. However, the Fifth Circuit vacated the district court's order which apportioned 10% of the fees to the secured creditor's collateral based on the amount of its claims in relation to the rest of the creditor claims. In remanding, the court instructed the district court to do its best to allocate the costs of the receivership to specific assets and then allocate them between secured and unsecured creditors "on the best basis it can determine." It also noted that the secured creditors should not be liable for the time spent on activities adverse to them or for services that only benefitted unsecured creditors. In *MW Capital Funding, Inc. v. Magnum Health and Rehab of Monroe LLC*, 2019 WL 3451221 (E.D. Mich. 2019), after acknowledging that receivers may surcharge a secured creditor's collateral for certain administrative expenses of a receivership estate, the district court declined the request in this case because the movant failed to demonstrate in quantifiable terms how the secured creditor benefitted.

Leveraging the Bankruptcy Code to

Conduct Receiver Sales of Real Property

By Kathy Bazoian Phelps
Diamond McCarthy LLP
kphelps@diamondmccarthy.com

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I. Introduction

The Bankruptcy Code contains clear provisions for Court approval of sales of real property and how to manage disputed liens, claims and encumbrances. Other than procedural guidelines for how to sell real property, there are no comparable substantive laws for Receivers about how to navigate around disputed liens and other sale issues that arise in receivership cases. This paper addresses how a Receiver can utilize certain provisions in the Bankruptcy Code to streamline real property sales in receiverships and maximize value for their estates.

II. A Sale Free and Clear of Disputed Liens Can Be Appropriate, Even in Receivership

Federal Rule of Civil Procedure 66 provides that "the practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts or with a local rule." Many federal district courts have adopted local rules that go one step further. For example, in the Central District of California, Local Rule 66-8 provides:

> Except as otherwise ordered by the Court, a receiver shall administer the estate as nearly as possible in accordance with the practice in the administration of estates in bankruptcy.

Assuming that the local practice in which a Receiver serves follows the guidance of the Bankruptcy Code and the presiding court is willing to entertain these principles, the Bankruptcy Code provides ample authority for sales free and clear of liens where the liens are the subject of a *bona fide* dispute. 11 U.S.C. § 363(f). Section 363(b)(1) of the Bankruptcy Code provides that, after notice and a hearing, the trustee may sell property of the estate other than in the ordinary course of business. Section 363(f) empowers the trustee to sell property out of the ordinary course of business "free and clear of any interest in such property of any entity" if one of the following five conditions is present:

(1) applicable non-bankruptcy law permits sale of such property free and clear of such interest;

(2) such entity consents;

(3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) such interest is in bona fide dispute; or

(5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

Section 363(f) is written in the disjunctive – satisfaction of one of the five conditions is sufficient to sell property free clear of liens. *In re Elliot*, 94 B.R. 343, 345 (Bankr. D.Pa. 1988).

A. Section 363(f)(3): Adequate Protection

A sale under § 363(f) is subject to the adequate protection requirement. S.REP.NO. 989, 95th Cong., 2d Sess. 57 (1978). Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale. *Id*.

The sale of the receivership estate's properties free and clear of liens and interests is proper under the guidance of § 363(f) in a few different scenarios. First, pursuant to § 363(f)(3), if the Receiver intends to sell property where the price obtained is greater than the aggregate value of all liens on such property, then the sale could be permitted to go forward provided that the liens attach to the sale proceeds and the Receiver has otherwise complied with 28 U.S.C. § 2001 regarding the procedures of sale designed to ensure that the Receiver has obtained a fair price for the property.

Receivers must take care to comply with the procedural requirements imposed under Title 28 regarding the sales process. Section 2001 specifically does not apply to actions under Title 11 (the Bankruptcy Code), but it does apply to Receivers. That section provides in relevant part:

> (b) After a hearing, of which notice to all interested parties shall be given by publication or otherwise as the court directs, the court may order the sale of such realty or interest or any part thereof at private sale for cash or other consideration and upon such terms and conditions as the court approves, if it finds that the best interests of the

> estate will be conserved thereby. Before confirmation of any private sale, the court shall appoint three disinterested persons to appraise such property or different groups of three appraisers each to appraise properties of different classes or situated in different localities. No private sale shall be confirmed at a price less than two-thirds of the appraised value. Before confirmation of any private sale, the terms thereof shall be published in such newspaper or newspapers of general circulation as the court directs at least ten days before confirmation. The private sale shall not be confirmed if a bona fide offer is made, under conditions prescribed by the court, which guarantees at least a 10 per centum increase over the price offered in the private sale.

B. Section 363(f)(4): *Bona Fide* Dispute

Another basis on which to sell free and clear of liens is if there are disputed liens or claims made against the property. A Receiver may sell a property for a price that assumes the disputed lien will be avoided pursuant to § 363(f)(4), even though the aggregate value of the liens, including the disputed lien, may exceed the sale price. Section 363(4) requires that the dispute be the subject of a "*bona fide* dispute."

One possible scenario in which a Receiver could seek to avoid a lien under § 363(f)(4) is if the Receiver seeks to avoid a lien as an alleged fraudulent transfer. Both the Bankruptcy Code and all state statutes provide for the avoidance of fraudulent transfers on both an actual and a constructive fraud basis. One court expressly addressed the application of § 363(f) in a receivership case when the Receiver sought permission to sell certain real property that was subject to liens which the Receiver contended were avoidable as fraudulent transfers. Rather than requiring the conclusion of the fraudulent transfer litigation before authorizing the sale of the property, the Court found that the *bona fide* dispute over the liens satisfied § 363(f)(4) and the Receiver could proceed with the sale of the properties in the intervening time. *See SEC v. Capital Cove Bancorp, LLC et al*, 2015 U.S. Dist. LEXIS 174856, * (C.D. Cal Oct. 13, 2015), a copy of which is attached hereto as Exhibit "1."

In the *Capital Cove* case, the court approved the sale of real property over the objection of secured creditors holding liens against the property. The court looked to the Bankruptcy Code for guidance in determining whether the Receiver could sell the property free and clear of liens even where the sales price was less than the amount of the liens on the property. In considering whether § 363(f)(4) applied, the court noted that the Receiver would have to demonstrate an objective basis for the dispute. In that case, the Receiver argued that the disputed liens were voidable under the Uniform Voidable Transfer Act.[1] The Ninth Circuit has unequivocally and repeatedly held that, under California law, transfers made in furtherance of a Ponzi scheme are presumed to have been made with actual fraudulent intent and are recoverable as avoidable fraudulent transfers. *See, e.g., Barclay v. Mackenzie* (*In re AFI Holding, Inc.*), 525 F.3d 700, 704 (9th Cir. 2008) (quoting *Hayes v. Palm Seedlings Partners - A* (*In re Agric. Research & Tech. Grp., Inc*.), 916 F.2d 528, 534 (9th Cir. 1990) ("[T]he mere existence of a Ponzi scheme is sufficient to establish actual intent" to hinder, delay or defraud."); *see also Donell v. Kowell*, 533 F.3d 762, 767 (9th Cir. 2008); *In re United Energy Corp.*, 944 F.2d 589, 590 n. 1 (9th Cir.1991) ("The fraud consists of funneling proceeds received from new investors to previous investors in the guise of profits from the alleged business venture, thereby cultivating an illusion that a legitimate profit-making business opportunity exists and inducing further investment.").

The transferee of the lien which is the subject of the dispute may assert a good faith defense in response to the Receiver's attempt to sell free and clear of that lien in an effort to defeat the Receiver's attempt to establish a bona fide dispute. In *Capital Cove*, the court evaluated both the

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[1] The Uniform Avoidable Transfer Act, formerly known as the Fraudulent Transfer Act ("UFTA"), as adopted by California pursuant to Cal. Civ. Code § 3439.04(a), states in relevant part:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation as follows:
>
> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor.

Receiver's evidence on actual fraudulent intent as well as the lienholders' assertion of a good faith value defense and found the existence of a bona fide dispute as to the avoidability of the liens. The Receiver should therefore be prepared to address a good faith value defense. Both the Bankruptcy Code in § 548(c) and state fraudulent transfer statutes recognize the existence of the good faith value defense. The Receiver should be prepared to address both the good faith and the value components of this likely defense, at least in a manner sufficient to establish a bona fide dispute.

In addition to the good faith defense, a secured lender may try another approach to challenge the *bona fide* dispute finding in the context of avoidance of a lien. For example, a secured lender might argue that pursuant to the express terms of the Deed of Trust and applicable state law, the lender holds a duly perfected lien against the real property and is entitled to full payment of all sums due under the loan documents as a condition to the release of the lien. A secured creditor might argue that the Receiver is obligated to honor the lien interest pursuant to 28 U.S.C. § 959(b), which provides:

> Except as provided in section 1166 of title 11, a trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

A secured creditor might argue that the Court's "equitable authority does not extend to abrogating property rights created by state law and protected by due process…" *S.E.C. v. Haligiannis*, 608 F.Supp.2d 444, 449 (S.D.N.Y. 2009) (citing *Hedges v. Dixon County*, 150 U.S. 182 (1893)). "The mere fact that a party is obliged to go into a federal court of equity to enforce an essentially legal right arising upon a contract valid and unassailable under controlling state law does not authorize that court to modify or ignore the terms of the legal obligation upon the claim, or because the court thinks that these terms are harsh or oppressive or unreasonable." *Manufacturers' Finance Co. v. McKey*, 294 U.S. 442, 448-49 (1935).

Another challenge might be made under state law. *Marshall v. People of State of New York,* 254 U.S. 380, 385 (1920) ("a receiver appointed by a federal court takes property subject to all liens, priorities, or privileges existing or accruing under the laws of the state.") For example, under California law, a secured creditor might argue that, as a matter of operation of law, a real property lien is not avoidable. In California:

> A real property loan generally involves two documents, a promissory note and a security instrument. The security instrument secures the promissory note. This instrument entitles the lender to reach some asset of the debtor if the note is not paid. In California, the security instrument is most commonly a deed of trust (with the debtor and creditor known as trustor and beneficiary and a neutral third party known as trustee). The security instrument may also be a mortgage (with mortgagor and mortgagee, as participants). In either case, the creditor is said to have a lien on the property given as security, which is also referred to as collateral.

Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1235, 44 Cal. Rptr. 2d 352, 357, 900 P.2d 601, 606 (1995) (emphasis added; internal citations omitted); *see also Susilo v. Wells Fargo Bank, N.A.,* 796 F. Supp. 2d 1177, 1189 (C.D. Cal. 2011) (citing *Hatch v. Collins,* 225 Cal.App.3d 1104, 275 Cal.Rptr. 476 (1990)).

As a matter of equity, a secured creditor might argue that to the extent a party's security interest is defined and established under applicable state law, neither the SEC, a receiver, nor a court in equity has the power to change or alter the rights afforded by that interest. *S.E.C. v. Spongetech Delivery Systems, Inc.,* 2015 WL 1509361, at *5 (E.D.N.Y 2015). "Further, to the extent that one debt is secured and another is not there is manifestly an inequality of rights between the secured and unsecured creditors, which cannot be affected by the principal of equality of distribution." *S.E.C. v. Management Solutions, Inc.,* 2013 WL 594738, at *3 (D. Utah, 2013) (citing *Ticonic Nat. Bank v. Sprague*, 303 U.S. 406 (1938)).

A secured creditor might also argue that it has a Fifth Amendment argument against a receiver's request to sell its collateral under United States v. Sec. Indus. Bank, 459 U.S. 70, 75 (1982).

In the context of avoiding a lien under § 522(f), that court held, "The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation." To avoid the resulting constitutional problem, the Court held that only liens granted after the effective date of § 522 could be avoided under it and that § 522 is not retroactive. Therefore, since nothing in federal law authorizes a receiver's sale of a secured creditor's collateral, arguably the Fifth Amendment requires the court to preserve the secured creditor's property interest in the collateral.

Nevertheless, if the court finds an objective basis for a *bona fide* dispute and is willing to follow the guidance of the Bankruptcy Code, a sale free and clear of liens even where the purchase price is less than the amount of the liens might be possible.

III. Using the Good Faith Purchaser Requirements of the Bankruptcy Code

Section 363(m) of the Bankruptcy Court serves to maximize value in bankruptcy cases by encouraging buyers to participate in bankruptcy sales. Section 363(m) assures a buyer that a sale approved by the Bankruptcy Court will not be modified by an appellate court after a sale transaction closes under certain conditions. Section 363(m) provides:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

The practical implication is, if the court concludes that the buyer acted in good faith, and if a reviewing court does not stay the sale of property prior to closing, then a reversal or modification of the order authorizing the sale does not unwind the transaction. Once a good faith purchaser closes the sale, absent a stay of the closing, the buyer has the assurance that the sale will stand. Section 363(m) serves the important public-policy consideration of maximizing value, which is a fundamental goal of the Bankruptcy Code. *Toibb v. Radloff*, 501 U.S. 157 (1991). Section 363(m) protects the finality of bankruptcy sales and thereby maximizes the value of a debtor's estate by providing assurance to buyers who will be more inclined to participate in the sales process when they know that their deal will not be modified by an appellate court after a sale transaction closes. *Weingarten Nostat, Inc. v. Serv. Merch. Co.*, 396 F.3d 737 (6th Cir. 2005).

The same public policy considerations apply in an equity receivership case. If a good faith finding is requested by a Receiver who establishes that the buyer purchased the property in good faith, and there is not stay pending appeal, then the sale can close despite a subsequent appeal, thereby preserving the value for the estate.

A good faith finding requires a review of the purchaser's conduct in the course of the sale proceedings. "Typically, misconduct that would destroy a purchaser's good faith status at a judicial sale involves fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders." *In re Abbotts Dairies of Pennsylvania*, 788 F.2d 143, 147 (3d Cir. 1986).

Of course, a party could seek a stay of the order which, if granted, would eliminate the protection of § 363(m). Under § 363(m), the party must first seek relief from the bankruptcy court. The party can move the district court or bankruptcy appellate panel to stay the order only if the party can show why they did not obtain the stay from the bankruptcy court. In either scenario, a party must meet certain criteria to obtain a stay. For example, in the Third Circuit, the party must establish four elements to obtain a stay: 1) a strong likelihood of success on the merits of the appeal; 2) the movant will suffer substantial irreparable injury if the stay is denied; 3) substantial harm will not be suffered by the other parties if the stay is granted; and 4) issuance of the stay would not harm the public interest. *In re Bankr. Appeal of Allegheny Health, Educ. & Research Found.*, 252 B.R. 309, 321 (W.D. Pa. 1999). The party seeking the stay carries a heavy burden, and courts will consider the harm to the public interest if the buyer walks and the estate loses the sale proceeds.

If a district court is willing to entertain the application of the principals in § 363(m) to a receivership sale, practitioners should review the law in their jurisdictions relating to whether § 363(m) automatically moots an appeal of an order approving a sale under all circumstances. The courts of appeals are split on this issue. The First, Second, Fifth, Eleventh, and D.C. Circuits have held that, in the absence of a stay of the sale order, the court must dismiss a pending appeal as moot unless the purchaser did not act in good faith. *Old Cold*, 879 F.3d at 383; *U.S. v. Salerno*, 932 F.2d 117 (2d Cir. 1991); *In re Sneed Shipbuilding, Inc.*, 916 F.3d 405 (5th Cir. 2019); *In re Steffen*, 552 F. App'x 946 (11th Cir. 2014); *In re Magwood*, 785 F.2d 1077 (D.C. Cir. 1986). The Fourth Circuit in *In re Ern, LLC*,124 F. App'x 151, 152 (4th Cir. 2005) (unpublished ruling) dismissed an appeal of a sale order as moot because the assets had been transferred and there was not stay pending appeal). The Eighth Circuit *In re Trism, Inc.*, 328 F.3d 1003, 1007 (8th Cir. 2003) , held that an appeal was moot under § 363(m) and that reversing a provision of an order authorizing the sale of the debtor's assets would adversely alter the parties' bargained-for exchange. The Ninth Circuit in *Lind v. Spacone* (*In re Lind*), 2019 Bankr. Lexis 2052, at *10 (June 20, 2019 9th Cir BAP) held that a sale could not be modified or set aside on appeal unless it was stayed pending appeal. The Court held that, "It was not stayed, so what remains of the appeal is statutorily moot."

Other circuits, including the Third, Sixth, Seventh, and Tenth Circuits, have rejected the view that § 363(m) automatically moots an appeal. Rather, they find that an appeal is not moot so long as it is possible to grant effective relief without impacting the validity of the sale. *See In re ICL Holding Co., Inc.*, 802 F.3d 547, 554 (3d Cir. 2015) (section 363(m) did not moot an appeal since the court could order redistribution of the sale proceeds without disturbing the sale); *Brown v. Ellmann (In re*

Brown), 851 F.3d 619 (6th Cir. 2017) (finding that parties alleging statutory mootness under § 363(m) must prove that the reviewing court is unable to grant effective relief); *Trinity 83 Dev., LLC v. ColFin Midwest Funding, LLC*, 917 F.3d 599 (7th Cir. 2019) (holding that § 363(m) of the Bankruptcy Code does not moot an appeal involving a dispute over the proceeds of a sale of assets in bankruptcy); *Osborn v. Duran Bank & Trust Co. (In re Osborn)*, 24 F.3d 1199 (10th Cir. 1994) (holding that an appeal of a sale order was not mooted by § 363(m) when under Texas state law a constructive trust could be imposed on the sale proceeds), *abrogated in part on other grounds by Eastman v. Union Pac. R.R.*, 493 F.3d 1151 (10th Cir. 2007); *In re C.W. Min. Co.*, 740 F.3d 548, 555 (10th Cir. 2014) (section 363(m) will moot appeals in cases where the only remedies available are those that affect the validity of the sale).

EXHIBIT 1

Securities and Exchange Commission v. Capital Cove Bancorp LLC et al.

Case No. SACV 15-980-JLS (JCx)

UNITED STATES DISTRICT COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA

2015 U.S. Dist. LEXIS 174856

***October 13, 2015*, Decided**
***October 13, 2015*, Filed**

COUNSEL: [*1] ATTORNEYS FOR PLAINTIFF: Not Present.

ATTORNEYS FOR DEFENDANT: Not Present.

JUDGES: Present: Honorable JOSEPHINE L. STATON, UNITED STATES DISTRICT JUDGE.

OPINION BY: JOSEPHINE L. STATON

OPINION

CIVIL MINUTES -- GENERAL

PROCEEDINGS: (IN CHAMBERS) ORDER GRANTING RECEIVER'S MOTIONS FOR ORDER AUTHORIZING (1) SALE OF REAL PROPERTY BY PUBLIC AUCTION FREE AND CLEAR OF LIENS, CLAIMS, AND ENCUMBRANCES OR, IN THE ALTERNATIVE, ABANDONMENT OF OVER-ENCUMBERED PROPERTIES (Doc. 71), (2) ESTABLISHING CLAIMS BAR DATE, (3) APPROVING FORM AND MANNER OF NOTICE, (4) APPROVING PROOF OF CLAIM FORM AND SUMMARY PROCEDURES, (5) STAYING POST-RECEIVERSHIP INTEREST, AND (6) ESTABLISHING THE NET INVESTMENT METHOD FOR FIXING INVESTOR CLAIMS (Doc. 73)

Before the Court are two Motions filed by Receiver Robert Mosier.[1] The Receiver filed a Motion for Entry of an Order Authorizing (1) Sale of Real Property by Public Auction Free and Clear of Liens, Claims, and Encumbrances, or (2) in the Alternative, Abandonment of Over-Encumbered Properties. (Sale Mot., Doc. 71.) The Receiver also filed a Motion for Entry of an Order (1) Establishing Claims Bar Date, (2) Approving Form and Manner of Notice, (3) Approving Proof of Claim Form and Summary Procedures, (4) [*2] Staying Post-Receivership Interest, and (5) Establishing the Net Investment Method for Fixing Investor Claims. (Claims Bar Mot., Doc. 73.) A number of interested parties opposed, (Docs. 98, 99, 101, 104, 107, 116), the Receiver replied, (Docs. 110, 111, 136), and two interested parties filed surreplies with leave of court, (Docs. 140, 141). Having considered oral argument and the briefs taken under submission, the Court GRANTS the Receiver's Motions.

1 The Court notes that the Receiver's 39-page Motion for Entry of an Order Authorizing the Sale of Real Property far exceeds the 25-page limit imposed by the Local Rules and the Court's Standing Order. C.D. Cal. R. 11-6. *See also* Initial Standing Order ¶ 10(c), Doc. 18. In addition, Local Rule 11-8 requires any memorandum of points and authorities over 10 pages in length to contain a table of contents and table of authorities. C.D. Cal. R. 11-8. The Receiver also failed to comply with this local rule. The Court may -- and typically does --

strike any motion that fails to comply with the Local Rules. *See Christian v. Mattel, Inc.*, 286 F.3d 1118, 1129 (9th Cir. 2002). Here, the Court addresses the merits of the Receiver's Motions. However, counsel for the Receiver is ordered to carefully review the applicable rules before [*3] filing any other documents in this Court, and any future filings that fail to comply with the Local Rules or the Court's Standing Order will result in (1) the striking of the non-compliant filing and/or (2) sanctions.

I. BACKGROUND

On June 18, 2015, Plaintiff Securities and Exchange Commission filed suit against Defendants Christopher M. Lee (a.k.a. Rashid K. Khalfani) and Capital Cove Bancorp, LLC. (*See* Compl., Doc. 1.) The SEC's complaint alleges that Defendants have violated (1) the antifraud provisions of Section 17(a) of the Securities Act of 1993, 15 U.S.C. § 77q(a), (2) the antifraud provisions of Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), (3) Rule 10b-5 of the Exchange Act, 17 C.F.R. § 240.10b-5, (4) the registration provisions of Section 5 of the Securities Act, 15 U.S.C. § 77e(a) and 77e(c), and (5) Sections 203 and 207 of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-3, 80b-7. (Compl. ¶¶ 10-12.)

On that same day, the Court entered a Temporary Restraining Order and Order to Show Cause Why Preliminary Injunction Should Not Be Granted pursuant to the SEC's Ex Parte Application. (TRO, Doc. 5.) The TRO ordered Defendants to comply with securities laws, prohibited the destruction of evidence, ordered Defendants to provide to the SEC an accounting of assets, and froze Defendants' assets. The TRO also appointed Robert Mosier as the temporary [*4] receiver over Defendants' assets. (Id. at 8.)

On June 29 and 30, 2015, the Receiver filed his initial reports. (First Report, Doc. 35; First Supp. Report, Doc. 37.) The Receiver reported that CCB and its more than thirty related entities are financially insolvent, and that Defendants engaged in ***Ponzi***-like activities by repaying existing investors with new investor monies. (First Report at 5-9; First Supp. Report at 2-4, Exs. 1-5.) The Receiver further reported the commingling of the entities' monies, the notable absence of corporate books and records, and a Morgan Stanley brokerage account statement that Khalfani admittedly altered "to show cash on hand." (First Report at 5-6, 9, Exs. A, D.) Investigations into CCB's books and records later revealed at least six other alterations to brokerage account statements since August 2013. (Supp. Pearson Decl. ¶¶ 5-6, 10-11, Exs. A-N, Doc. 77.)

The Receiver states that his work "reveals to a near certainty that the collective assets of Capital Cove will be insufficient to pay claimants 100% of the amounts claimed." (Mosier Decl. ¶ 5, Doc. 73.) The Receiver is aware of more than thirty real properties owned by Defendant CCB or its affiliates,[2] many with [*5] multiple encumbrances. (Mosier Decl. ¶¶ 5, 10-36, Exs. 1-26, Doc. 71.) Recorded liens against these thirty properties total approximately $17.8 million. (Second Supp. Report at 3, Doc. 48.) The Receiver proposes an initial sale of twenty-six properties,[3] and he estimates that the potential gross recovery from that sale may be in the range of $10.7 million to $12.3 million. (Third Supp. Report at 2, Doc. 85.) The total loan amounts of the first trust deeds on each of the twenty-six properties is approximately $9.5 million. (Third Supp. Report at 3.) The interest to be claimed by the first trust deed holders from the date of appointment through November 30, 2015, the likely date of closing sales, is approximately $1.1 million. (Third Supp. Report at 3.) The Receiver states that he received payoff demands from one of the secured lenders which, if left in place, would make the Defendants' estate insolvent "within a few months." (Claims Bar Mot. at 11; Mosier Decl. Ex. 3.)

2 The Receiver has found that the following companies are affiliates of CCB: Capital Cove International, Inc., Capital Cove Asset Management, Inc., Capital Cove Financial, Capital Cove Financial Services, Inc., Capital Cove [*6] Asset Management, Capital Cove Real Estate, Capital Cove Real Estate Advisors, Capital Cove Realty Group, Capital Cove REO Opportunities Fund LLC, Capital Cove REO Opportunities Fund II, Capital Cove REO

Opportunities Fund III, Capital Cove REO Opportunities Fund IV, REO Multi Asset Fund Holdings, Inc., Capital Cove Investment Management, Inc., Capital Cove Advisory, Capital Cove Financial Advisory Services LLC, Rittenhouse Square Trust LLC, Rittenhouse Square Advisory LLC, Aspyration Capital Advisors, Inc., Aspyration Financial Group, Inc., Nepenthe Capital Management Inc., Diversified Realty and Financial Services, Inc., Portovelo Management Group LLC, Portovelo Financial, Portovelo Development, Portovelo Wealth Management, First Asian Bancorp LLC, First Asian Management. (*See* Mosier Decl. ¶ 4, Doc. 73 at 16-17.)

3 The Court has already authorized the Receiver to sell the following properties free and clear of liens, claims, and encumbrances: 520 N. Valley Center Ave., Glendora, CA 91741; 9564 Delmar Ave., Hesperia, CA 92345; 2136 W. 20th Street, Los Angeles, CA 90018; 1447 E. Pumalo Ave., San Bernardino, CA 92404; 2979 West Birch Street, San Bernardino, CA 92376; 945 West 2nd Street, [*7] Rialto, CA 92376; 842 Sheffield Way, Perris, CA 92571; 6926 Eastwood Ave., Rancho Cucamonga, CA 91701 (Ex Parte Order Re: Assorted Properties, Doc. 43; Ex Parte Order Re: Eastwood, Doc. 53.)

The Receiver has identified approximately sixty-nine investors who seek recovery from the estate. (Third Supp. Report at 3.) A number of investors have subordinate trust deeds on the properties, and many have opted to release those deeds to assert a claim in the receivership estate. (Id.) The Receiver has informally estimated these claims to fall within $5 to $10 million. (Id.) A majority of investors have no recorded trust deed against any property, despite promises by CCB to the contrary. (Second Supp. Report at 3.) The investment amounts for those investors with no recorded trust deeds are "crudely estimated" to be $4 million. (Id.) The Receiver believes there will be sufficient equity to pay off the first trust deeds on each property, but he estimates that some second trust deeds--as well as most third, fourth, and fifth trust deeds--will be under-secured. (Id. at 3 n.2.)

On September 1, 2015, the Court granted the SEC's Application for Preliminary Injunction and appointed Mosier as the permanent receiver. [*8] (PI Order, Doc. 96; Concurrent PI Order at 9, Doc. 97.) In relevant part, the permanent receivership appointment directs the Receiver to (1) take custody of any real or personal property owned or managed by Defendants, (2) have control of all accounts of the entities in receivership, (3) conduct investigations and discovery as may be necessary to locate and account for all the assets owned or managed by Defendants, (4) take any necessary actions to preserve and prevent the dissipation or concealment of those assets, (5) make an accounting of the assets and financial condition of Defendants, and (6) make any payments or disbursements as necessary in discharging his duties as temporary receiver. (Concurrent PI Order at 10-12.)

On August 14, 2015, the Receiver filed a Motion for Entry of an Order Authorizing (1) Sale of Real Property by Public Auction Free and Clear of Liens, Claims, and Encumbrances, or (2) in the Alternative, Abandonment of Over-Encumbered Properties. (Sale Mot., Doc. 71.) The Receiver also filed a Motion for Entry of an Order (1) Establishing Claims Bar Date, (2) Approving Form and Manner of Notice, (3) Approving Proof of Claim Form and Summary Procedures, (4) Staying [*9] Post-Receivership Interest, and (5) Establishing the Net Investment Method for Fixing Investor Claims. (Claims Bar Mot., Doc. 73.)

Interested parties filed oppositions to these Motions.[4] Dan Baer, Dennis Wesley, Joanne Wesley, and Creative Asset Management LLC, senior lienholders on four of the properties at issue (together "CAM"), oppose the Receiver's request to hold segregated sale proceeds pending resolution of lien issues and requests that it receive payment, interest, fees, charges, payment of certain commissions, and permission to credit bid during the proposed sale. (CAM Sale Opp. at 2-10, Doc. 98.) Center Street Lending Fund IV, LLC and Center Street Lending Fund V, LLC (together "CS Lending"), also senior lienholders, oppose the Receiver's request to hold a sale free and clear of liens with respect to the properties in which it has an interest. (CS Lending Opp. at 12-18, Doc. 104.) Investors Roman P. Mosqueda, Kristine Joy Mosqueda, and Ryan Christopher Mosqueda (together

"Mosqueda") state they "have no opposition" to the Receiver's Motions as long as they are paid "before any unsecured creditors are paid therefrom." (Mosqueda Opp. ¶ 5, Doc. 91.) Jose Moreno, Antonio Moreno, Georgina Moreno, Mario Moreno, and Emilia Moreno [*10] (together "Moreno") request that the Court exclude the property located at 2222 W. Garvey Ave. from the proposed sale. (Moreno Opp. at 7-15, Doc. 101.) CAM and CS Lending also ask that the Court decline to stay the accrual of their default interest rates as of June 18, 2015. (CAM Interest Opp. at 8, Doc. 99; CS Lending Opp. at 14.)

4 A number of beneficiaries who invested through Cervenka & Lukes Capital Partners also jointly opposed the proposed stay of post-receivership non-default interest. (C&L Opp., Doc. 107.) The Receiver reached a settlement with C&L and the C&L Beneficiaries on the issues raised in their Opposition, (Claims Bar Reply at 3 n.1, Doc. 111), and the C&L Beneficiaries indicated they would formally withdraw their Opposition upon court approval of their settlement, (Notice of Withdrawal, Doc. 151). Because the Court approved the terms of this settlement agreement on September 30, 2015, the Court considers the C&L Opposition withdrawn and it does not address the issues raised in the Opposition. (*See* Ex Parte Order, Doc. 149). Another interested party, German Centeno, initially requested that the Court exclude the property located at 1350 Hollencrest Drive from the proposed sale. (Centeno Opp. at 4-9, Doc. 116.) At the hearing, counsel for the Receiver [*11] and Centeno stated they had reached a settlement agreement in principal and that they request that the Court remove the Hollencrest property from the list of properties to be sold. The Court therefore considers Centeno's Opposition withdrawn and does not address the issues raised in this Opposition.

On September 22, 2015, CS Lending filed an Ex Parte Application to strike new arguments raised in the Receiver's reply briefs or, in the alternative, for leave to file a surreply addressing these arguments, and CAM filed a Joinder to this Application. (*See* App., Doc. 124; Joinder, Doc. 126.) The Receiver filed an Opposition, which the SEC joined. (Ex Parte Opp., Doc. 130; SEC Joinder, Doc. 132.) The Court granted leave for CS Lending and CAM to file a surreply brief, which they timely filed. (*See* Surreply Order, Doc. 135; CS Lending Surreply, Doc. 140; CAM Surreply, Doc. 141.)

II. LEGAL STANDARD

"The power of a district court to impose a receivership or grant other forms of ancillary relief . . . derives from the inherent power of a court of equity to fashion effective relief." *SEC v. Wencke*, 622 F.2d 1363, 1369 (9th Cir. 1980). "[A] primary purpose of equity receiverships is to promote orderly and efficient administration of the estate by [*12] the district court for the benefit of creditors." *SEC v. Hardy*, 803 F.2d 1034, 1038 (9th Cir. 1986). To that end, "[a] district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad." *SEC v. Capital Consultants, LLC*, 397 F.3d 733, 738 (9th Cir. 2005) (internal quotation marks and citation omitted). "The basis for this broad deference to the district court's supervisory role in equity receiverships arises out of the fact that most receiverships involve multiple parties and complex transactions." *Hardy*, 803 F.2d at 1037.

III. DISCUSSION

The oppositions to the Receiver's Motions are limited to (1) the Receiver's proposed sale of properties "free and clear" of all liens, including his proposal to sell certain properties at a value less than the aggregate value of all existing liens and his proposal to hold sale proceeds in segregated accounts before distribution, (2) CAM's request as to certain fees, costs, and the opportunity to credit bid, (3) the Receiver's inclusion of the 2222 W. Garvey Ave. property in his proposed sale, and (4) the Receiver's request that the Court stay post-receivership default interest as to over-secured creditors. The Court addresses each issue in turn.

A. The Proposed Sale of Properties "Free [*13] **and Clear" of All Liens**

The Court first addresses CAM and CS Lending's opposition to the Receiver's proposed sale of properties "free and clear" of all liens. Both CAM and CS Lending argue that upon the Receiver's sale of properties in which they have an interest, the Receiver should pay them immediately rather than have their liens attach to the proceeds.

Pursuant to the provisions of 28 U.S.C. § 2001, this Court may authorize the Receiver to sell acquired assets by public sale. Moreover, "it has long been recognized that under appropriate circumstances, a federal court presiding over a receivership may authorize the assets of the receivership to be sold free and clear of liens and related claims." *Pennant Mgmt., Inc. v. First Farmers Fin., LLC*, No. 14-CV-7581, 2015 WL 4511337, at *4 (N.D. Ill. July 24, 2015) (quoting *Regions Bank v. Egyptian Concrete Co.*, No. 09-cv-1260, 2009 WL 4431133, at *7 (E.D. Mo. Dec. 1, 2009)). *See also Mellen v. Moline Malleable Iron Works*, 131 U.S. 352, 357 (1889) ("[T]he removal of alleged liens or incumbrances [sic] upon property, the closing up of affairs of insolvent corporations, and the administration and distribution of trust funds are subjects over which courts of equity have general jurisdiction.").

The Receiver argues that this case is an appropriate circumstance for authorizing such a sale. (Sale Reply at 13, Doc. 110.) Because Local Rule 66-8 directs a receiver to "administer the estate as nearly [*14] as possible in accordance with the practice in the administration of estates in bankruptcy[,]" the Court looks to the Bankruptcy Code for guidance. C.D. Cal. R. 66-8. Section 363(f) of the Bankruptcy Code empowers the trustee of an estate to sell the estate's property "free and clear of any interest in such property of an entity" if any one of the following five conditions is present: (1) an applicable non-bankruptcy law permits such a sale, (2) the entity at issue consents, (3) the interest is a lien and the property's selling price is greater than the aggregate value of all liens on such property, (4) the interest is in a bona fide dispute, or (5) the entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. 11 U.S.C. § 363(f). Because Section 363(f) is written in the disjunctive, satisfaction of any one condition is sufficient to sell the property "free and clear of any interest." *Id.; In re Elliot*, 94 B.R. 343, 345 (Bankr. E.D. Pa. 1988) ("[I]f any of the five conditions of § 363(f) are met, the Trustee has authority to conduct the sale free and clear of all liens.").

The Receiver argues that a sale "free and clear" of interests is proper under Sections 363(f)(3) and 363(f)(4). First, the Receiver intends to sell a majority of the identified properties at a price "sufficient to pay the [*15] liens then existing." (Sale Mot. at 7.) The multiple interests on these properties are liens.[5] For those properties that will obtain a selling price greater than the aggregate value of all liens on the properties, Section 363(f)(3) weighs in favor of authorizing a sale "free and clear" of interests. Second, the Receiver's counsel noted at the hearing that a handful of properties are unlikely to sell at a price greater than the aggregate value of all existing liens. The Receiver argues he should have the authority to sell those properties at a lower price because the relevant senior liens, those of senior lenders CAM and CS Lending, are in a bona fide dispute under Section 363(f)(4). (*See* Sale Reply at 14-15.)

> 5 Under the Bankruptcy Code, a lien is a "charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(37). This definition generally includes "inchoate liens," "judicial liens, security interests, and statutory liens." *See* S. Rep. No. 95-989, at 25 (1978).

To establish a "bona fide dispute" under Section 363(f)(4), the moving party must "provide some factual grounds to show some objective basis for the dispute." *See In re Kellogg-Taxe*, No. 2:12-BK-51208-RN, 2014 WL 1016045, at *6 (Bankr. C.D. Cal. Mar. 17, 2014) (citing *In re Gaylord Grain LLC*, 306 B.R. 624, 627 (B.A.P. 8th Cir. 2004)). "[A] court need not determine [*16] the probable outcome of the dispute, but merely whether one exists." *Id.* (internal quotation marks and citation omitted). "However, not any alleged dispute satisfies [Section 363(f)(4)]. It clearly entails some sort of meritorious, existing conflict." *In re Taylor*, 198 B.R. 142, 162 (Bankr. D.S.C. 1996) (citing *In re Atlas Machine & Iron Works v. Bethlehem Steel*, 986 F.2d 709 (4th Cir. 1993)).

The Receiver argues that the disputed liens are voidable under the Uniform Voidable Transfer Act,[6] which states in relevant part:

> (a) A transfer made or obligation incurred by a debtor is voidable as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation as follows:
>
>> (1) With actual intent to hinder, delay, or defraud any creditor of the debtor.

Cal. Civ. Code § 3439.04(a), *as amended by* 2015 Cal. Legis. Serv. Ch. 44 (S.B. 161). "The purpose of [the UVTA] is to permit the receiver to collect those assets that can actually be located and recovered in the wake of a ***Ponzi*** scheme, and to ratably distribute those assets among all participants, including the many investors who lost everything." *Donell v. Kowell*, 533 F.3d 762, 779 (9th Cir. 2008). Moreover, the "mere existence of a ***Ponzi*** scheme, which could be established by circumstantial evidence, has been found to fulfill the requirement of actual intent on [*17] the part of the debtor." *In re Agric. Research and Tech. Grp.*, 916 F.2d 528, 536 (9th Cir. 1990). *See also In re Cohen*, 199 B.R. 709, 717 (B.A.P. 9th Cir. 1996) ("Proof of a ***Ponzi*** scheme is sufficient to establish the ***Ponzi*** operator's actual intent to hinder, delay, or defraud . . . .").[7]

6 The UVTA amended and superseded the Uniform Fraudulent Transfer Act. *See* 2015 Cal. Legis. Serv. Ch. 44 (S.B. 161).

7 Courts have found that whether fraudulent transfers are made "with actual intent" to hinder, delay, or defraud creditors is the same under the Bankruptcy Code and the UVTA. *See, e.g., In re Cohen*, 199 B.R. at 717.

First, the Court addresses whether the disputed liens in question may be voidable under the UVTA. The UVTA defines a "transfer" as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with an asset or an interest in an asset, and includes payment of money . . . and *creation of a lien* or other encumbrance." Cal. Civ. Code § 3439.01(i) (emphasis added). The Receiver may therefore seek to void a lien under the UVTA.

Next, the Court turns to whether the Receiver has demonstrated a sufficient, objective basis for a dispute under the UVTA. In the Receiver's Reports to the Court, he provides evidence that Defendants engaged in a ***Ponzi*** scheme. CCB claimed to be a real estate and investment services firm focused [*18] primarily on real estate-owned properties. (Ma Decl. Exs. 42, 44, 74, Doc. 13.) But Khalfani made material misrepresentations to investors, promising first or second trust deeds on properties while recording third, fourth, or fifth trust deeds, or recording none at all, in exchange for their investments. (First Supp. Report at 2-4; Second Supp. Report at 7.) CCB primarily used one bank account for all its current entities, which resulted in the commingling of investor dollars and operating funds. (First Report at 5, Doc. 35.) Tracing of investor funds reveals that Defendants paid earlier investors and covered CCB operating costs with new investor money. (First Supp. Report at 2-4, Exs. 1-5; Second Supp. at 3.) "Distributing funds to earlier investors from the receipt of monies from later investors is the hallmark of ***Ponzi*** schemes." *In re Agric. Research*, 916 F.2d 528, 536

(9th Cir. 1990). The real properties in Defendants' estate therefore constituted a key component of Defendant's alleged ***Ponzi*** scheme. Negotiating senior liens on these properties facilitated Defendants' purchase of the properties, and the circumstances demonstrate that Defendants pursued such liens in furtherance of the alleged ***Ponzi*** scheme.

The Court therefore finds that the Receiver has [*19] demonstrated a sufficient, objective basis to support the existence of a ***Ponzi*** scheme furthered by the disputed liens. However, a good faith defense exists under the UVTA. A transfer is not voidable under Section 3439.04(a)(1) against a person who "took in good faith and for a reasonably equivalent value . . . ." Cal. Civ. Code § 3439.08(a). "The issue of good faith under [the UVTA] is a defensive matter as to which the [parties] asserting the existence of good faith have the burden of proof." *See In re Cohen*, 199 B.R. at 719; *see also* Cal. Civ. Code §§ 3439.08(a), 3439.08(f)(1), *as amended by* 2015 Cal. Legis. Serv. Ch. 44 (S.B. 161). "One lacks the good faith that is essential to the [UVTA] if possessed of enough knowledge of the actual facts to induce a reasonable person to inquire further about the transaction." *In re Cohen*, 199 B.R. at 719. "Such inquiry notice suffices on the rationale that some facts suggest the presence of others to which a transferee may not safely turn a blind eye." *Id.* Courts therefore "look to what the [creditor] objectively 'knew or should have known' in questions of good faith, rather than examining what the [creditor] actually knew from a subjective standpoint." *In re Agric. Research*, 916 F.2d at 535-36.

The Court first addresses whether CS Lending is entitled to the good faith defense. CS Lending has made 88 loans to Defendants totaling [*20] approximately $19.6 million, and it argues that it performed its due diligence by (1) completing a background check on Khalfani and (2) reviewing CCB's Articles of Organization. (Couig Decl. ¶¶ 9, 16, 17, Doc. 104-1.) However, the Receiver's evidence demonstrates that almost immediately after initiating the lending relationship, Defendants were late in making their required payments. (Mosier Decl. ¶ 14, Exs. 1-2, Doc. 110.) At least 63 loans were in default at some point during the lending relationship, and Defendants defaulted on as many as twenty loans in a given month. (Mosier Decl. ¶¶ 13, 14, Exs. 1-2, Doc. 110.) Moreover, CS Lending was aware of the SEC's investigation before it entered into several new loan transactions with Defendants. (Mosier Decl. ¶ 17, Ex. 3, Doc. 110.) This evidence suggests that CS Lending "possessed [] enough knowledge . . . to induce a reasonable person to inquire further about the transaction[s]." *In re Cohen*, 199 B.R. at 719. The evidence therefore demonstrates there is a bona fide dispute as to the voidability of CS Lending's liens under the UVTA.

The Court then turns to CAM. CAM has made eight loans to Defendants, and it similarly argues that it performed its due diligence before agreeing to make these loans. (*See* Baer [*21] Decl. ¶ 19, Doc. 100.) CAM states it personally inspected each property and examined comparable sales to determine whether the property value was adequate to protect each loan. (Baer Decl. ¶¶ 5, 7, 9, 11, 13, 15, 17.) CAM also notes that Defendants timely made all payments on four loans, (id. ¶¶ 6, 8, 10, 12), and that all payments were current on the four remaining loans prior to the Receiver's appointment, (id. ¶¶ 12, 14, 16, 18). However, CAM admits that in early June 2015, it "began to become concerned that Capital Cove may be having cash flow problems stemming from delay in closing several acquisitions." (Baer Decl. ¶ 21). The Receiver states he "[is] advised" that CAM agreed to make four loans to CCB in February 2015, but that three loans were delayed for a period of months because CCB "could not raise sufficient capital to acquire new properties." (Mosier Decl. ¶ 21, Doc. 110.) CAM emailed Khalfani on June 11, 2015, requesting to meet regarding Khalfani's inability to close escrow on one such property. The email states:

> You have not signed the loan documents, an additional $146,503.53 is required to close escrow, the deadline to close is tomorrow, June 12, 2015, the Seller, and [*22] Seller's agent are very worried and deeply concerned, and no one has heard from you. I realize that you are having cash flow problems, but you can't treat people like "mushrooms" (i.e., keeping them in the dark and feeding them a load of manure). I want to work with you, R.K., but you have got to help me to help you.

(Mosier Decl. Ex. 4, Doc. 110.) CAM states that Khalfani assured it he was in the process of funding the escrow at issue, and Khalfani fully funded and closed the escrow within two business days after the email exchange. (Baer Decl. ¶ 21.) Around this time, Defendants closed the sale of one property and the acquisition of two others in which CAM had an interest. (Id.) CAM states that "[a]t that point, [it] felt reassured by Capital Cove's continuing performance that nothing was amiss." (Id.)

It is critical here that for the purposes of Bankruptcy Code Section 363(f)(4), the Court "need not determine the probable outcome of the dispute, but merely whether one exists." *In re Kellogg-Taxe*, 2014 WL 1016045, at *6. The circumstances surrounding CAM's latter three loans indicate that Defendants were suffering cash flow problems that delayed several real estate acquisitions underlying those loans. Although Khalfani appeared to later remedy his money shortfalls, [*23] the initial delays were noteworthy enough to cause growing concern. (*See* Baer Decl. ¶ 21.) Moreover, the evidence suggests that Defendants obscured or failed to disclose their situation when engaging in real estate transactions. A mere day before escrow closed on the above property, Khalfani told CAM he was "in the process of funding the [] escrow." (Baer Decl. ¶ 21.) Funds necessary to close the escrow were lacking on the eve of the closing deadline, the seller and seller's agent were "very worried and deeply concerned," and yet "no one" working with Khalfani on the real estate transaction "ha[d] heard from [him]" until CAM sent the above-referenced email. (Mosier Decl. Ex. 4, Doc. 110.) The evidence provides some objective basis that CAM "possessed [] enough knowledge . . . to induce a reasonable person to inquire further about the transaction." *In re Cohen*, 199 B.R. at 719. The Court therefore finds there is a bona fide dispute as to the voidability of CAM's liens under the UVTA.[8]

8 CAM and CS Lending note the Receiver has yet to bring an action to avoid the disputed liens. (CAM Surreply at 2, Doc. 141; CS Lending Surreply at 5, Doc. 140.) However, the disputed liens "need not be the subject of an immediate or concurrent adversary proceeding" to raise a bona [*24] fide dispute under Section 363(f)(4). *See In re Kellogg-Taxe*, 2014 WL 1016045, at *6 (citing *In re Gaylord Grain LLC*, 306 B.R. at 627).

Because the Court finds the liens of CS Lending and CAM are in a bona fide dispute under Section 363(f)(4), it may authorize the Receiver to approve the highest auction bidding price for those affected properties even if that price is insufficient to cover the aggregate value of all existing liens. However, CS Lending argues the Court should nevertheless decline to do so because (1) the Receiver improperly raised this request in a reply brief, (2) the relief would violate CS Lending's due process rights, and (3) the Receiver has not provided any justification for this relief. (CS Lending Surreply at 4-10, Doc. 140.)

CS Lending correctly notes "[i]t is improper for a moving party to introduce new facts or different legal arguments in the reply brief than those presented in the moving papers." *U.S. ex rel. Giles v. Sardie*, 191 F. Supp. 2d 1117, 1127 (C.D. Cal. 2000) (citing *Lujan v. Nat'l Wildlife Fed'n*, 497 U.S. 871, 894-95 (1990)). However, the Court granted leave for CS Lending and CAM to file surreplies addressing new matters raised in the Receiver's reply briefs. (*See* Doc. 134.) CAM and CS Lending were therefore provided "notice and an adequate opportunity to reflect and to respond[,]" thereby satisfying their due process rights. *See In re Loloee*, 241 B.R. 655, 662 (B.A.P. 9th Cir. 1999). At the hearing, CS Lending requested another opportunity to respond to the Receiver's [*25] arguments. Because the Court already provided an opportunity to file a surreply, it declines to grant this request.

Moreover, CS Lending is also protected by the adequate assurance requirement for sales pursuant to Section 363(f). 11 U.S.C. § 363(e). "The concept of adequate protection finds its basis in the Fifth Amendment's protection of property interests." *In re DeSardi*, 340 B.R. 790, 797 (Bankr. S.D. Tex. 2006) (citing H.R. Rep. No. 95-595, 338-40 (1977), as reprinted in 1978

U.S.C.C.A.N. 6294-6297.). "Most often, adequate protection in connection with a sale free and clear of other interests will be to have those interests attach to the proceeds of the sale." S. Rep. 95-989, at 56 (1978). "Typically, the proceeds of sale are held subject to the disputed interest and then distributed as dictated by the resolution of the dispute; such procedure preserves all parties' rights by simply transferring interests from property to dollars that represent its value." *In re Clark*, 266 B.R. 163, 171 (B.A.P. 9th Cir. 2001). In this case, liens will attach to the proceeds of the sale "with those liens, claims, and encumbrances to maintain the same force, effect, and priority against the sales proceeds as existed at the time of the closing of the sale." (*See* Proposed Order ¶ 5, Doc. 155-1.) The Court therefore finds that adequate assurance exists in [*26] this case.

Finally, the Court addresses CS Lending's concern that the Receiver has not explained how this relief is in the best interests of the receivership estate. The Receiver has provided compelling evidence of (1) the large number of unsecured and junior creditors who were defrauded and await recovery in this case, and (2) the Receiver's expected inability to pay the full amount of each claim from the pooled assets of Defendants' estate. It is therefore in the best interest of the receivership estate to sell the affected properties at the highest possible market price, even if that price falls below the aggregate value of existing liens, rather than abandoning those properties.

Accordingly, the Court authorizes the Receiver to sell the identified properties through public auction. For those properties affected by the bona fide dispute as to CAM and CS Lending's liens, the Receiver may approve the highest bidding price even if it is insufficient to cover the aggregate value of all existing liens. For all other properties, the Receiver may only approve a sale price sufficient to cover the aggregate value of all existing liens. To promote the equitable distribution of Defendants' assets, [*27] and given the bona fide dispute at issue here, the Court approves the Receiver's request to hold sale proceeds in segregated accounts in lieu of immediate distribution.[9] (*See* Proposed Order P 5, Doc. 155-1.) Should the Receiver seek to void the liens of CAM or CS Lending, he must initiate this process **within 28 days** of this Order.

9 Mosqueda states they have no opposition to the Receiver's motion "provided that the proceeds from the auction sale thereon are held in a segregated account, subject to payment of their liens-claims thereon before any unsecured creditors are paid therefrom." (Mosqueda Opp. at 2.) The proceeds from the auction sale will be held in segregated accounts, and liens will attach to the proceeds of the sale "with those liens, claims, and encumbrances to . . . maintain the same force, effect, and priority against the sales proceeds as existed at the time of the closing of the sale." (*See* Proposed Order ¶ 5, Doc. 155-1.)

B. CAM's Request for Various Fees, Commissions, and Permission to Credit Bid

Next, the Court addresses CAM's request for various fees, charges, and commissions. CAM first argues that any order authorizing the sale should require payment of "attorneys' fees and other charges [*28] to which [CAM is] lawfully entitled under their promissory notes, deeds of trust and California law." (CAM Sale Opp. at 8, Doc. 98.) CAM then requests permission to credit bid for any properties in which it holds a security interest. (Id. at 8-9.) Finally, CAM argues that broker Hamilton Cove Realty, Inc. is entitled to a 2.5% commission for the sale of five identified properties. (Id. at 9-10.)

The Receiver argues that because there is a bona fide dispute as to CAM's liens, ordering the payment of attorneys' fees and charges is premature. (Sale Reply at 3.) 11 U.S.C. § 506(b) provides that the holder of "an allowed secured claim [that] is secured by property the value of which . . . is greater than the amount of such claim" is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose." 11 U.S.C. § 506(b). However, if CAM's liens are voidable under the UVTA, CAM will not have "an allowed secured claim" giving rise to the "reasonable fees, costs, or charges" provided by this statute. *See id.* Accordingly, in light of the Court's finding that a bona fide dispute exists as to CAM's liens, the Court declines to order the payment of CAM's fees and costs at this time. [*29]

The Court then turns to CAM's request to credit bid on the properties in which it has an alleged interest. Although secured creditors may credit bid under 11 U.S.C. § 363(k), courts may deny this opportunity "for cause." *See* 11 U.S.C. § 363(k). "Intrinsically, acting 'for cause' looks to the court's equity powers that allow the court to balance the interests of the debtor, its creditors, and the other parties of interests in order to achieve the maximization of the estate and an equitable distribution to all creditors." *In re RML Dev., Inc.*, 528 B.R. 150, 155 (Bankr. W.D. Tenn. 2014) (citing *Florida Dept. of Revenue v. Picadilly Cafeterias, Inc.*, 554 U.S. 33, 51 (2008); *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 527 (1984); *Katchen v. Landy*, 382 U.S. 323, 336 (1966)).

A number of equitable considerations justify the denial of CAM's request to credit bid. The Court takes note of the SEC's prima facie case of Defendants' securities fraud, the Receiver's evidence of a ***Ponzi*** scheme, the numerous investors and creditors that were defrauded by Defendants, the Receiver's finding that Defendants' collective assets will be insufficient to pay 100% of all amounts claimed, and the Receiver's intent to equitably distribute recovery among all those who were harmed. Allowing CAM to credit bid would harm the many unsecured and junior creditors who also await recovery. This conclusion is further supported by the Court's finding that a bona fide dispute exists as to CAM's [*30] liens against the properties at issue. Accordingly, the Court finds it has justifiable "cause" to deny CAM's request to credit bid.

Finally, the Court addresses CAM's argument that Hamilton Cove Realty is entitled to a 2.5% commission due upon the sale of applicable property. In the bankruptcy context, a broker has only a "general unsecured claim" for brokerage commissions if he fully performed his brokerage services before the petition was filed. *See In re Moskovic*, 77 B.R. 421, 423 (Bankr. S.D.N.Y. 1987); *In re Godwin Bevers Co., Inc.*, 575 F.2d 805, 807-08 (10th Cir. 1978). Here, HCR fully performed its brokerage services before this proceeding began. (*See* CAM Sale Opp. at 9; Baer Decl. Ex. 9 ¶ 10.) HCR does receive its commission upon completion of the property's sale, but the timing of the sale--namely, the Court's authorization that the sale take place during this proceeding--does not elevate HCR's claim beyond its "general, unsecured" status. *See In re Godwin Bevers Co.*, 575 F.2d at 808. Accordingly, the Court declines to order the immediate payment of HCR's commission at the expense of other claimants. To the extent HCR believes it has a claim against the estate, it must file a claim along with the other unsecured claimants in this case.

C. Sale of Property at 2222 W. Garvey Ave.

The Court turns to Moreno's request that the Court exclude the 2222 W. Garvey Ave. [*31] property from the Receiver's proposed sale. On August 25, 2015, Moreno filed an action in state court alleging (1) declaratory relief, (2) quiet title, (3) partition, (4) breach of contract, (5) common counts, (6) fraud, and (7) intentional interference with prospective economic advantage with respect to this property. (Moreno Opp. at 6-7; Skovholt Decl. ¶ 4, Ex. A, Doc. 103.) Moreno therefore requests that the Court exclude the property from the proposed sale so the interested parties may continue with their state court action. (Moreno Opp. at 15-16.)

However, Moreno provides no legal basis for why the Court should do so. In fact, it is well established that "the court first assuming jurisdiction over property may exercise that jurisdiction to the exclusion of other courts." *Colorado River Water Conservation Dist. v. United States*, 424 U.S. 800, 818 (1976); *see also Sexton v. NDEX West*, LLC, 713 F.3d 533, 536 (9th Cir. 2013) ("[I]f a state or federal court has taken possession of property, or by its procedure has obtained jurisdiction over the same, then the property under that court's jurisdiction is withdrawn from the jurisdiction of the courts of the other authority as effectually as if the property had been entirely removed to the territory of another sovereign."). The SEC's Complaint was filed in the instant action on June 18, 2015, and the 2222 Garvey Ave. [*32] property was first identified by the Receiver as a part of Defendants' estate in his First Receiver's Report on June 29, 2015. (First Report, Ex. B at 3, Doc. 35.) The Court's Temporary Restraining Order, filed on June 18, 2015, "immediately authorized, empowered and directed" the Receiver to "take custody, control, possession, and charge" of all assets managed by CCB, including all real property "wherever located." (TRO at 8-9.) Moreno filed a complaint in state court on August 25, 2015, nearly two months later. (Skovholt Decl. ¶ 4, Ex. A, Doc. 103.)

Next, the Court turns to Moreno's request to exclude the Garvey Ave. property from the sale so they may trace and reclaim the property under theories of equitable relief. The Court finds that the Moreno's proffered theories of equitable relief do not justify the exclusion of the Garvey Ave. property. "Courts have favored pro rata distribution of assets where, as here, the funds of the defrauded victims were commingled and where victims were similarly situated with respect to their relationship to the defrauders." *SEC v. Credit Bancorp. Ltd.*, 290 F.3d 80, 88-89 (2d Cir. 2002). Equitable relief such as constructive trusts may be "useful to work out equity between a wrongdoer and a victim; but, when [*33] the fund with which the wrongdoer is dealing is wholly made up of the fruits of the frauds perpetrated against a myriad of victims, the case is different." *Cunningham v. Brown*, 265 U.S. 1, 13 (1924). As the Eleventh Circuit explained:

> To allow any individual to elevate his position over that of other investors similarly 'victimized' by asserting claims for restitution and/or reclamation of specific assets based upon equitable theories of relief such as fraud, misrepresentation, theft, etc. would create inequitable results, in that certain investors would recoup 100% of their investment while others should receive substantially less . . . . In the context of this receivership the remedy of restitution to various investors seeking to trace and reclaim specific assets as originating with them is disallowed as an inappropriate equitable remedy.

SEC v. Elliot, 953 F.2d 1560, 1569 (11th Cir. 1992) (citation omitted) (affirming the district court's decision to disallow tracing). *See also In re North Am. Coin & Currency, Ltd.*, 767 F.2d 1573, 1575 (9th Cir. 1985) ("We necessarily act very cautiously in exercising such a relatively undefined equitable power in favor of one group of potential creditors at the expense of other creditors, for ratable distribution among all creditors is one of the strongest policies behind the bankruptcy laws.").

Here, Defendants [*34] perpetrated fraud against a myriad of victims whose funds are commingled. Allowing various investors to "trace and reclaim specific assets . . . is [therefore] disallowed as an inappropriate equitable remedy." *Elliot*, 953 F.2d at 1569. Accordingly, the Court declines to exclude the Garvey Ave. property from the Receiver's proposed sale.

D. Stay of Post-Receivership Interest

Both CAM and CS Lending also challenge the Receiver's proposed stay of post-receivership default interest of their senior liens.[10] (*See* CAM Interest Opp. at 5-8; CS Lending Opp. at 16.)

> 10 The Receiver also requests a stay of "all post-receivership interest as to all investor and unsecured and under-secured creditor claims." (Proposed Order ¶ 10, Doc. 75-1.) Although there is no opposition to this request, the Court notes that 11 U.S.C. § 502(b)(2) disallows the recovery of unmatured interest by unsecured and under-secured creditors as of the petition date. 11 U.S.C. § 502(b)(2). Interest is considered "'unmatured' when it was not yet due and payable at the time the debtor filed its bankruptcy petition." *Thrifty Oil Co. v. Bank of Am. Nat'l Trust and Sav. Ass'n*, 322 F.3d 1039, 1046 (9th Cir. 2002). "As a general rule, after property of an insolvent passes into the hands of a receiver or of an assignee in insolvency, interest is not allowed on the claims against the funds." *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163 (1946). This general rule "achieve[s] fairness and administrative [*35] efficiency" because "denying post-petition interest ensures that no party realizes a gain or suffers a loss due to the delays inherent in liquidation and distribution of the estate." *Thrifty Oil Co.*, 322 F.3d at 1047.

As noted above, receivers should "administer the estate as nearly as possible in accordance with the practice in the administration of estates in bankruptcy." C.D. Cal. R. 66-8. The Bankruptcy Code permits interest on secured creditor's claims only to the extent the value of the secured property exceeds the amount of the claim. *See* 11 U.S.C. § 506(b). CAM, CS Lending, and the Receiver disagree whether the value of the properties is sufficient to satisfy the principal of CAM and CS Lending's claims. Even assuming that the property values exceed the contested claims, however, the Court finds it may stay post-receivership default interest under equitable considerations.

In the bankruptcy context, courts have found that a secured creditor's entitlement to default interest under 11 U.S.C. § 506(b) is subject to equitable considerations, including whether the application of default interest will harm junior or unsecured creditors. *See, e.g., Gen. Elec. Capital Corp. v. Future Media Prods. Inc.*, 547 F.3d 956, 960 (9th Cir. 2008) (noting that a party's default interest is "subject . . . to reduction based upon any equities involved."); [*36] *In re 785 Partners LLC*, 470 B.R. 126, 134 (Bankr. S.D.N.Y. 2012) (stating that post-petition default interest may not be allowed where "the application of the contractual interest rate would harm the unsecured creditors."); *In re Jack Kline Co. Inc.*, 440 B.R. 712, 747 (Bankr. S.D. Tex. 2010) (applying a "balancing of the equities test" to determine whether to apply post-petition default interest); *In re DWS Invs., Inc.*, 121 B.R. 845, 849-50 (Bankr. C.D. Cal. 1990) (refusing to apply a post-petition default interest rate in part because "[t]he estate is insolvent and the unsecured creditors are unlikely to receive a distribution" if the rate is applied). In fact, courts have recognized that this consideration of whether junior or unsecured creditors will be harmed "has special significance." *In re Jack Kline Co.*, 440 B.R. at 747 (finding that "this factor weighs heavily against allowing any default interest rate charged by Central Bank.").

The Receiver argues "[i]t cannot seriously be disputed" that the accrual and imposition of post-receivership default interest will harm junior and unsecured creditors. (Claims Bar Reply at 6, Doc. 111.) Because the Receiver provides substantial evidence that Defendants' collective assets will be insufficient to pay all claimants 100% of the amounts claimed, and that many unsecured and junior creditors are most at risk for losing their potential recoveries, the Court finds that ongoing default [*37] interest rates would directly harm junior and unsecured creditors. "It is manifest that the touchstone of each decision on allowance of interest in . . . receivership . . . has been a balance of equities between creditor and creditor or between creditors and the debtor." *Green*, 329 U.S. at 165. As a result, the Court finds that staying all post-receivership default interest satisfies the "primary purpose" of receiverships, which is "to promote orderly and efficient administration of the estate" for the benefit of all creditors. *See Hardy*, 803 F.2d at 1038.

IV. CONCLUSION

For the foregoing reasons, the Court GRANTS the Receiver's Motions. The Court enters two concurrently-filed Orders.

Biography of Kathy Bazoian Phelps

Kathy Bazoian Phelps
Diamond McCarthy LLP
1999 Avenue of the Stars, Suite 1100
Los Angeles CA 90067
310-651-2997 (office)
310-488-4883 (cell)
kphelps@diamondmccarthy.com

Kathy Bazoian Phelps is senior counsel at Diamond McCarthy LLP in the Los Angeles office and has been a lawyer since 1991. She practices in the area of bankruptcy law and fraud litigation, and frequently represents bankruptcy trustees and state and federal receivers, as well as serving as a federal equity receiver and Chapter 11 trustee herself. She represents litigants and parties in interest in bankruptcy and receivership cases and other insolvency proceedings. She is particularly knowledgeable about the administration of Ponzi scheme cases and has extensive litigation experience in claims arising in these types of cases and in tracing and recovering assets.

Kathy has lectured widely and written on bankruptcy and receivership matters, with a focus on Ponzi schemes. Her book entitled *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes*, co-authored with Hon. Steven Rhodes, has garnered national and international attention as the authoritative work on Ponzi scheme law. In addition to her roles as lawyer, speaker and author, Kathy also serves as a mediator and is currently on the mediation and arbitration rosters for the Financial Industry Regulatory Authority, as well as the Bankruptcy Mediation Panel for the Central District of California and the Bankruptcy Mediation Panel for the District of Arizona.

Work Experience

- Diamond McCarthy LLP in Los Angeles California, 2013 to present.
- Danning, Gill, Diamond & Kollitz, LLP in Los Angeles California: 1991 – 2013.

Principal Publications

- *The Ponzi Book: A Legal Resource for Unraveling Ponzi Schemes.* co-authored with Hon. Steven Rhodes (Ret.) (LexisNexis® 2012)
- *Fraud and Forensics: Piercing Through the Deception in a Commercial Fraud Case*, co-author (American Bankruptcy Institute 2015)
- *Ponzi-Proof Your Investments: An Investor's Guide to Avoiding Ponzi Schemes and Other Fraudulent Scams* (IRR Publishing 2013)
- *The Depths Of Deepening Insolvency: Damage Exposure For Officers, Directors and Others*, co-authored with Prof. Jack F. Williams (American Bankruptcy Institute 2013)
- Author of *The Ponzi Scheme Blog* at www.theponzischemeblog.com

The Powers of a Receiver in an Equity Receivership to

Assume or Reject Executory Contracts

By
Hon. Steven Rhodes
United States Bankruptcy Judge (Ret.)
Eastern District of Michigan

NAFER Annual Conference, October 2020

I. Introduction

Section 365 of the Bankruptcy Code empowers a Chapter 11 debtor or a bankruptcy trustee to "assume or reject" an executory contract to which the debtor was party at the time of the bankruptcy filing. As explained below, this power provides the debtor or the trustee with substantial flexibility in administering estate assets for the benefit of creditors while minimizing estate liabilities, especially liabilities that have an administrative expense priority.

In *Mission Prod. Holdings, Inc. v. Tempnology, LLC*, 139 S. Ct. 1652, 1658 (2019), the Supreme Court observed:

> Section 365(a) enables the debtor (or its trustee), upon entering bankruptcy, to decide whether the contract is a good deal for the estate going forward. If so, the debtor will want to assume the contract, fulfilling its obligations while benefiting from the counterparty's performance. But if not, the debtor will want to reject the contract, repudiating any further performance of its duties.

Similar benefits can be achieved in a federal equity receivership case if the equity court allows the receiver that same flexibility. Fortunately for receivers, and the creditors in their cases, the slim case law on this issue overwhelmingly favors granting the receiver that power.

These materials will first review the law of executory contracts under Section 365 of the Bankruptcy Code, because that law is generally followed in the receivership case law. This review of the bankruptcy law of executory contracts is only a primer—a summary review at the highest level—on a lengthy and complex provision of the Code. This primer should, however, be sufficient for most circumstances that receivers face. These materials will then review the equity receivership case law that has addressed this issue.

II. What is an Executory Contract?

The term "executory contract" is not defined in that Bankruptcy Code. In *Mission Prod. Holdings*, the Supreme Court stated that an executory contract is simply "a contract that neither party has finished performing." *Id., at* 1657; *see also N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 523 (1984) ("[T]he legislative history to § 365(a) indicates that Congress intended the term to mean a contract 'on which performance is due to some extent on both sides.' H.R.Rep. No. 95-595, p. 347 (1977), see S.Rep. No. 95-989, p. 58 (1977).").

In *Mission Prod. Holdings*, the Court continued, "Such an agreement represents both an asset (the debtor's right to the counterparty's future performance) and a liability (the debtor's own obligations to perform)." 139 S. Ct. at 1658.

III. Examples of Executory Contracts

Among the most common executory contracts are:

- Real and personal property leases
- Real and personal property sales contracts
- Collective bargaining agreements. *See, e.g.*, *Bildisco*, 465 U.S. at 521–22.
- Intellectual property license agreements. *See, e.g.*, *Mission Prod. Holdings*, 139 S. Ct. at 1662 (addressing a trademark license).

IV. Assumption of an Executory Contract

Section 365(b) allows the estate to assume an executory contract even if the debtor is in default of the contract, provided that the trustee or debtor: (a) cures, or provides adequate assurance that the trustee or debtor will promptly cure, the default; (b) compensates, or provides adequate assurance that the estate will promptly compensate, the contract counterparty, for any actual pecuniary loss resulting from such default; and (c) provides adequate assurance of future performance under such contract.

V. Rejection of an Executory Contract

Rejection of an executory contract has three consequences for the contract counterparty.

First, the contract counterparty has an unsecured prepetition claim for breach of contract damages against the estate. Under Section 365 of the Bankruptcy Code, "[T[he rejection of an executory contract or unexpired lease of the debtor constitutes a breach of such contract or lease—(1) . . . immediately before the date of the filing of the petition[.]" *See Mission Prod. Holdings*, 139 S. Ct. at 1658; *Bildisco*, 465 U.S. at 530 ("Consequently, claims arising after filing, such as result from the rejection of an executory contract, must also be presented through the normal administration process by which claims are estimated and classified.").

Section 502(g)(1) echoes this consequence:

> A claim arising from the rejection, under section 365 of this title or under a plan under chapter 9, 11, 12, or 13 of this title, of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

However, as the Supreme Court observed in *Mission Prod. Holdings*, this prepetition unsecured claim may not have much value:

> But such a claim is unlikely to ever be paid in full. That is because the debtor's breach is deemed to occur "immediately before the date of the filing of the [bankruptcy] petition," rather than on the actual post-petition rejection date. § 365(g)(1). By thus giving the counterparty a pre-petition claim, Section 365(g) places that party in the same boat as the debtor's unsecured creditors, who in a typical bankruptcy may receive only cents on the dollar. See *Bildisco*, 465 U. S. at 531–532, 104 S.Ct. 1188 (noting the higher priority of post-petition claims).

Id.

The second consequence of the rejection of an executory contract for the contract counterparty is that the party is then excused from further performance on the executory contract. *Id*.

The third consequence is that the contract counterparty may choose to continue to perform and to retain its rights under the contract. That is because "[r]ejection of a contract—any contract—in bankruptcy operates not as a rescission but as a breach." *Mission Prod. Holdings*, at 1661. Nor does it operate as a termination of the contract. *Id.*, at 1662. Simply stated, the contract counterparty's rights upon rejection, which is nothing more than a breach of the contract, are the same in bankruptcy as they would be for the same breach outside of bankruptcy. The contract counterparty can choose to retain its rights under the contract by continuing to perform (even if it asserts a claim for the breach), or that party can terminate the contract (and still assert a claim for the breach). In *Mission Prod. Holdings*, the Court asserted this straightforward hypothetical case to explain this point:

> Consider a made-up executory contract to see how the law of breach works outside bankruptcy. A dealer leases a photocopier to a law firm, while agreeing to service it every month; in exchange, the firm commits to pay a monthly fee. During the lease term, the dealer decides to stop servicing the machine, thus breaching the agreement in a material way. The law firm now has a choice (assuming no special contract term or state law). The firm can keep up its side of the bargain, continuing to pay for use of the copier, while suing the dealer for damages from the service breach. Or the firm can call the whole deal off, halting its own payments and returning the copier, while suing for any damages incurred. See 13 R. Lord, Williston on Contracts § 39:32, pp. 701–702 (4th ed. 2013) ("[W]hen a contract is breached in the course of performance, the injured party may elect to continue the contract or refuse to perform further"). But to repeat: The choice to terminate the agreement and send back the copier is for the law firm. By contrast, the dealer has no ability, based on its own breach, to terminate the agreement. Or otherwise said, the dealer cannot get back the copier just by refusing to show up for a

> service appointment. *The contract gave the law firm continuing rights in the copier, which the dealer cannot unilaterally revoke.*
>
> * * *
>
> [Rejection] means, too, that the law firm has an option about how to respond—continue the contract or walk away, while suing for whatever damages go with its choice. . . . [A]ssuming the law firm wants to keep using the copier, the dealer cannot take it back. A rejection does not terminate the contract. When it occurs, the debtor and counterparty do not go back to their pre-contract positions. Instead, the counterparty retains the rights it has received under the agreement. As after a breach, so too after a rejection, those rights survive.

Id.

VI. The Court's Role

In *Mission Prod. Holdings*, the Supreme Court succinctly stated the trial court's role: "The bankruptcy court will generally approve that choice, under the deferential 'business judgment' rule." *Id*, at 1658.

VII. The "Special Interest" Exceptions in Section 365

At 3,803 words, Section 365 of the Bankruptcy Code is by far the Code's longest and most complex provision. One reason for this is that in virtually every act of Congress amending the Code since its enactment in 1978, special interest groups persuaded Congress to add specific provisions and exceptions for certain executory contracts. Among the executory contracts that get special treatment under Section 365 are shopping center leases under Section 365(b)(3), personal property leases under Section 365(d)(5) & (p), and intellectual property licenses under Section 365(n).

VIII. The Federal Equity Receivership Case Law Favors a Receiver's Power to Assume or Reject an Executory Contract

Only a handful of cases address this question head-on, but all support the receiver.

In *Janvey v. Alguire*, No. 3:09-CV-0724-N, 2014 WL 12654910, (N.D. Tex. July 30, 2014), *aff'd*, 847 F.3d 231 (5th Cir. 2017), the receiver for the Stanford entities filed claims under the Texas Uniform Fraudulent Transfer Act to recover money paid to employees of various Stanford entities. These employees sought to compel arbitration of the receiver's claims based on arbitration agreements included in the terms of contracts with the Stanford Group Company. The district court denied the employees' motion on the grounds that the receiver had rejected the executory arbitration agreements. The court concluded that "the Receiver has rejected the arbitration agreements and that these rejections were proper, based on the particular circumstances of this receivership." *Id.*, at *10. The court first concluded that the law in receivership cases was similar to the law in bankruptcy cases:

> First, while more recent receivership caselaw is sparse on the topic, based on the recent caselaw that does exist and the habit of courts in more dated opinions to cite bankruptcy and receivership cases almost interchangeably, the Court deems it reasonable to conclude that **the current state of equity receivership law on the "assume or reject" doctrine remains similar to bankruptcy law**. *See Resolution Trust Corp. v. CedarMinn Bldg. Ltd. P'ship*, 956 F.2d 1446, 1453 (8th Cir. 1992) ("It has been recognized for at least a century that receivers may repudiate contracts and leases." (collecting cases)); *see also Pa. Steel Co. v. N.Y.C. Ry. Co.*, 198 F. 721, 744 (2d Cir. 1912), *cited with approval by Cent. Trust Co. v. Chi. Auditorium Ass'n*, 240 U.S. 581, 589 (1916).

Id. (emphasis added).

The court then concluded that no formal act to reject an executory contract is necessary:

> Second, the Court determines that the Receiver in the present case has rejected the arbitration agreements. **Receivership caselaw is clear that federal equity receivers are under no obligation to affirmatively reject an executory contract.** *See Samuels v. E.F. Drew & Co.*, 292 F. 734, 739 (2d Cir. 1923) ("The receiver is under

> no obligation to renounce an executory contract. The contract is terminated, even though the receiver never renounces." (collecting cases)). Instead, "[t]here is a presumption that the receiver will not adopt a contract. If he does, it is a voluntary act of his own, to be performed with promptness...." *Id.*; *see also Menke v. Willcox*, 275 F. 57, 58–59 (S.D.N.Y. 1921) (Learned Hand, J.) ("[T]he mere inaction of receivers, where they do not enjoy any benefits from assets *cum onere*, is never of itself an adoption, though it may endanger their right to adopt. In order to be bound, they must positively indicate their intention to take it over."). This is fairly consistent with Chapter 7 liquidations under current bankruptcy law. See 11 U.S.C. § 365(d)(1) ("In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected."). The Court deems the Receiver's actions in filing this lawsuit in federal court against the Employee Defendants as rejection of the arbitration agreements. Furthermore, the Court notes that the significant amount of time that has passed without any sort of affirmative action by the Receiver in attempting to adopt either the Employee Defendants' arbitration agreements (or even the underlying contracts) also indicates rejection.

Id. (emphasis added).

Finally, the court concluded that rejecting the arbitration agreements at issue was permissible because of the burden they created for the estate:

> Lastly, t**he Court views the Receiver's rejections as permissible in the present case. If the Court required the Receiver to adopt these arbitration agreements, it would greatly burden and deplete the receivership estate. Such a result, weighed in the balance, would be unjust and inequitable.** *Cf. Fauci v. Mulready*, 337 Mass. 532, 536–37 (Mass. 1958) ("An equity receiver upon appointment is not bound to perform or adopt executory contracts and leases, unless directed to do so by the court which appointed him. In the absence of such orders, a receiver should reject any executory contract or lease, the performance of which will be burdensome and deplete the receivership estate."); *see also infra* Part IV.E (discussing burden arbitration would impose on Receiver).

Id. (emphasis added).

In *SEC v. Churchville*, No. CV 15-191 S, 2016 WL 3816373, (D.R.I. July 12, 2016), several "Acrewood" entities, relying on an agreement (the "ARCO" agreement) with the defendant that was entered into after the SEC filed its complaint but before the court appointed the receiver, filed a motion for payment of attorney fees. The SEC and the receiver opposed the motion.

The court first stated: "There is little case law relating to equitable receiverships. Accordingly, Acrewood and the Receiver rely on cases interpreting the U.S. Bankruptcy Code (the "Code") and the leading treatise on equitable receiverships, 2 Clark on Receivers (3rd ed. 1959). Both treat pre-petition and pre-receivership executory contracts such as the ARCO similarly." *Id.*, at *2. The court then reviewed the law of executory contracts under the Bankruptcy Code:

> Generally, under Chapter 11 of the Code, debtors in possession are liable for services performed under pre-bankruptcy contracts in two circumstances. First, the debtor in possession can expressly assume liability for pre-bankruptcy contracts, with court approval, at any time during the bankruptcy. 11 U.S.C. § 365(a). If the debtor in possession assumes the contract, "it assumes the contract *cum onere*, and the liabilities incurred in performing the contract will be treated as administrative expenses." *In re FBI Distribution Corp.*, 330 F.3d 36, 42 (1st Cir. 2003) (internal quotation marks and citations omitted). Second, where a debtor in possession induces a party to perform under an unassumed pre-petition contract, the party "will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate." Id. at 42-43. Where the debtor in possession elects to continue to receive benefits from a pre-petition contract prior to adopting the contract, the debtor in possession "is obligated to pay for the reasonable value of those services." *Id*. at 43-44 (emphasis in original) (quoting *N.L.R.B. v. Bildisco*, 465 U.S. 513, 531 (1984)). If, on the other hand, the debtor in possession rejects the contract and does not receive benefits from it, the other contracting party has a pre-petition general unsecured claim for breach of contract damages and is not entitled to any administrative priority. *Id*. at 42.

Id.

The court then concluded that the same law applies to executory contracts in equity receivership actions:

> The authority relating to equitable receiverships echoes this legal framework. While there is little case law on point, the leading treatise treats receivers in the same way bankruptcy case law treats debtors in possession. It first notes that "[t]he receiver is under no obligation to the parties to [a pre-receivership] contract to perform such contract on behalf of the debtor." Clark, supra, § 428. Rather, for a pre-receivership contract to bind a receiver, "the receiver must positively indicate his intention to take over the contract." *Id*. § 428(a). Further, where a receiver takes advantage of a pre-receivership contract without adopting it, "he may do so without necessarily committing himself to an adoption thereof." *Id*. Instead, the receiver is liable for "the value of the benefit [received by] the estate not exceeding the compensation stipulated by the contract." *Id*.

Id., at *3. Accordingly, the court concluded, "Based on these authorities, neither the Court nor the Receivership is bound by the ARCO." *Id.*

One case does establish an important caution for a receiver faced with an executory contract issue. In *Wiand v. Wells Fargo Bank, N.A.*, No. 8:12-CV-557-T-27EAJ, 2015 WL 12839237, (M.D. Fla. June 10, 2015), *report and recommendation adopted*, No. 8:12-CV-557-T-27EAJ, 2016 WL 355490 (M.D. Fla. Jan. 29, 2016), the receiver in the Arthur Nadel Ponzi scheme case opposed the bank's claim for the attorney fees that it had incurred in defending the receiver's litigation against it. The bank's attorney fee claim was based on a contract with the receivership entities. The receiver contended that the provisions for attorney fees were executory contracts which a receiver is entitled to repudiate and that he has tacitly rejected. The Magistrate Judge concluded:

> Even if this is true, while it is one thing to permit the Receiver to repudiate executory contracts which he determines are unprofitable or undesirable within a reasonable period of time after being appointed, **it is quite another to permit the Receiver to repudiate contracts at this late stage of the litigation where the Receiver is potentially liable for substantial attorneys' fees**.

Id., at *6. In a footnote here, the Magistrate Judge quoted from *U.S. Trust Co. v. Wabash W. Ry. Co.*, 150 U.S. 287, 299–300 (1893):

> A 'receiver is not bound to adopt the contracts, accept the leases, or otherwise step into the shoes of his assignor, if, in his opinion, it would be unprofitable or undesirable to do so; and he is entitled to a reasonable time to elect whether to adopt or repudiate such contracts.'

Id., at *6, n.11. In the end, however, the Magistrate Judge determined that it was not necessary to decide the executory contract issue, concluding that in any event, the contract did not support the bank's claim.

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THE BANKRUPTCY CODE AND RECEIVERSHIPS – CRACKING THE CODE

Session Producer: Ira Bodenstein – Cozen O'Connor

Session Panelists: Kyra Andrassy – Smiley Wang-Ekvall, LLP

Kathy Bazoian Phelps – Diamond McCarthy LLP

Hon. Steven Rhodes – U.S. Bankruptcy Judge (Ret.) E.D. Mich.

Jason L. Weiner – Highline Law, PLC

LEVERAGING THE BANKRUPTCY CODE TO CONDUCT RECEIVER SALES OF REAL PROPERTY

- Sales Free and Clear of Disputed Liens in a Receivership
- Federal Rule of Civil Procedure 66
- Use of Bankruptcy Code § 363(b)(1) and § 363(f)

LEVERAGING THE BANKRUPTCY CODE TO CONDUCT RECEIVER SALES OF REAL PROPERTY

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